Testimony of

Phillip L. Swagel

Before the Committee on Banking, Housing, and Urban Affairs
U.S. Senate

"Housing Finance Reform: Essential Elements of a Government Guarantee for Mortgage-Backed Securities"

Thursday, October 31, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to testify on housing finance reform. I am a professor at the University of Maryland's School of Public Policy and a faculty affiliate of the Center for Financial Policy at the Robert H. Smith School of Business at the University of Maryland. I am also a senior fellow with the Milken Institute's Center for Financial Markets and a visiting scholar at the American Enterprise Institute. I was previously Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009.

It is extraordinary for any private financial activity, asset, or firm to have a government guarantee. Any such guarantee should be strictly limited and with the terms and conditions that reflect the fact that it should be rare to have arrangements in which American taxpayers come to the rescue of those who made bad investments.

I see housing finance as an instance in which having an explicit government guarantee is a better policy than the alternative of not having one. Policymakers would feel obligated to intervene if mortgage loans were not available to Americans during a future financial crisis. This intervention would take place for social reasons because of the appropriately special place of housing in our society, and for economic reasons that reflect the importance of the housing sector for investment and consumption. Government officials would feel obligated to intervene if the market for mortgage securities locked up because these represent a vital part of U.S. financial markets and because problems in secondary markets would impair the flow of new mortgage origination.

This means that intervention by the government is latent. It would be better to formalize the government guarantee and have it priced so that taxpayers are compensated for providing a backstop in housing finance rather than allowing the government guarantee to remain implicit and unpriced. Unfortunately, it is not a simple matter to do away with the implicit guarantee in housing finance--it is not enough to simply say that there is no guarantee. A housing finance reform in which the government ostensibly does not guarantee housing would inadvertently recreate the implicit guarantee that was one of the worst aspects of the previous failed system. The implicit guarantee made it possible for private shareholders and management to receive the upside when Fannie Mae and Freddie Mac did well, but left taxpayers with the bailout when the firms faced collapse in 2008.

Any government guarantee creates moral hazard. This is not a problem to solve but a fact of life. The proper policy focus is on how to minimize the moral hazard, recognizing that the attendant incentives exist.

The question then is how to best structure the government involvement in housing finance to meet the goals of ensuring that mortgage financing is available across market conditions while protecting taxpayers from another costly bailout and guarding the U.S. financial system and overall economy from the systemic risks that arose in the past failed system. In doing so, it is important to ensure that the new housing finance system is durable. A future financial crisis is inevitable despite the best efforts of regulators and supervisors. Housing finance reform should take this into account.

In looking at the decisions involved with having the government provide a guarantee on MBS that is secondary to considerable private capital, an overarching point is that it is vital to spell out what happens when the government must make good on its guarantee. To be sure, the guarantee should be designed so that the taxpayer liability is far behind private capital. But eventually there will be another crisis severe enough to activate the guarantee; otherwise, there is no point in having one. With this in mind, I see the following key decisions in designing the guarantee.

<u>Switch the guarantee to MBS rather than entities</u>

The U.S. government now effectively stands behind Fannie Mae and Freddie Mac's insured mortgage-backed securities by guaranteeing those two firms as ongoing entities. It would be preferable to have the guarantee formalized--made explicit--and switched instead to attach to particular MBS rather than firms. This has several advantages. The first is that this change would allow for entry and competition into securitization and guaranty. In the past, the implicit government guarantee allowed Fannie and Freddie to fund themselves at an advantage of around 100 basis points compared to other financial firms. But the market power of the two firms meant that only around half of this implicit subsidy passed through to mortgage holders in the form of lower interest rates, with the balance going instead to shareholders and management of the two GSEs. Recent research provides further evidence that a lack of competition in the mortgage industry leads to higher interest rates for homebuyers.[1] Entry and competition will help prevent this situation, with competitive pressure pushing to homeowners any implicit subsidy from underpriced government insurance.

Entry and competition will further help address the problem of Too Big to Fail institutions. In the fall of 2008, policymakers felt obligated to avert the collapse of Fannie and Freddie to avoid a situation in which American families could not obtain mortgage lending and the banking system needed to be recapitalized en masse to offset losses on GSE securities. Allowing additional firms to participate in the activity of securitization and guaranty for mortgages that qualify for government backing will ensure that these firms can fail without the need for a bailout.

At the same time, it is possible that a future financial crisis will lead to the failure of many or even all firms that perform securitization and guaranty. In this case, it is likely that the government would feel

---

[1] David Scharfstein and Adi Sunderam, 2013. "Concentration in Mortgage Lending, Refinancing Activity, and Mortgage Rates," April. Available on http://www.people.hbs.edu/dscharfstein/Mortgage_Market_04-2013.pdf

obligated to intervene to keep one or more in operation. This could be done using the authorities in the Title II Orderly Resolution Authority of Dodd-Frank. Under Title II, the government could put money into a failing securitization and guaranty firm to ensure that at least one such entity remained operational to allow the continued flow of mortgage financing. A natural course of action would be for the assistance to be withdrawn as other private sector firms are constituted to enter the market. The government eventually would be repaid for any losses suffered as a result of this assistance, in this case by a tax on the rest of the financial system. There is thus the ability to maintain the flow of mortgage financing even in the face of industry-wide losses that swamp all participants in mortgage guaranty. A system of multiple firms each of which is allowed to fail is fully consistent with the idea that securitization activity must continue throughout a crisis.

The alternative to allowing competition and entry is to have a few firms—just one or two would be natural given the scale economies involved—that are guaranteed as entities. Such an arrangement would ensure the continuity of mortgage securitization, but give up the benefits of competition and innovation. A securitization cooperative in which the government backstop applies one vintage at a time likewise would miss out on benefits of competition for consumers and limit the extent to which mortgage industry participants suffer appropriate consequences in the event of failure. Continuity of the industry is important, but this can be assured without giving up other benefits of housing finance reform.

<u>Ensure considerable high-quality private capital ahead of the government guarantee</u>

Having substantial private capital in the first loss position will both protect taxpayers and provide market participants with an incentive for prudent behavior in mortgage origination. It would be useful to have private capital in a variety of forms and through multiple mechanisms. In particular, private capital should be present at both the level of the individual loan through homeowner down payments and private mortgage insurance, and at the level of mortgage-backed security. For individual loans, the salient role of underwater borrowers since the collapse of the housing bubble has made clear the importance of homeowner equity. The collapse of Fannie and Freddie likewise made clear the importance of capital at the level of the securitization. MBS-level capital can be put in place in through both common equity of the firm that performs the securitization and purchases the government guarantee, and through various forms of risk transfer. This could include subordinated MBS tranches or other capital market structures such as credit-linked notes, or through capital provided by MBS insurers, provided that this insurance capital is strictly overseen to ensure that it represents risk-bearing capacity.

The key in all cases is to ensure that the private capital can bear losses when they come, recognizing that this could be in the midst of a difficult financial market environment. In the recent financial crisis, insurance capital was problematic in some instances, as highly-rated insurers such as AIG did not have the financial wherewithal to make good on their commitments when needed. This suggests a preference for equity capital and for capital market structures such as subordinated securities in which it is clear in advance that the financial resources exist to bear losses. It is possible for investors to use leverage in capital markets transactions—the purchasers of a credit-linked note, for example, could borrow the funds with which to take on that risk. But such concerns are omnipresent—the risk will exist somewhere, and ultimately the regulators of other industry participants must be relied on to ensure the soundness of the banking system (if this is the provider of leverage in housing). The key for housing finance reform is for the housing credit risk taken on by private investors ahead of the government to be clearly identified and funded.

<u>10 percent capital requirement</u>

The Housing Finance Reform and Taxpayer Protection Act (S. 1217) includes a 10 percent capital requirement at the MBS level, in addition to the norm of a 20 percent capital requirement at the level of the individual mortgage from homeowner equity and private mortgage insurance. This 10 percent MBS capital requirement is both appropriate and essential. By way of comparison, the total losses of Fannie Mae and Freddie Mac were shy of 5 percent of their assets, so a 10 percent requirement represents a considerable amount of capital. Indeed, there is a sense in which a 10 percent capital requirement at the MBS level is closer to 100 percent than the current capital requirement of zero, since 10 percent would have been enough for the two firms to have made it through the crisis. I recognize that the existence of an explicit guarantee is a huge step for people concerned about bailouts and the adverse effects of government intervention in housing finance. A 10 percent capital requirement should provide considerable comfort that taxpayers are protected from future bailouts.

At the same time, it should be kept in mind that the losses at Fannie and Freddie in all likelihood would have been considerably higher had the government not intervened to support the housing market, not just through the injection of capital into the two firms but also through the actions of the Federal Reserve in purchasing over a trillion dollars of the two firms' securities. Such quantitative easing by the Fed effectively reduced the losses at the GSEs. This suggests caution in looking at a 5 percent capital requirement as sufficient. A future system with 10 percent capital would not have to rely on such unprecedented central bank or taxpayer intervention to withstand a repeat of the recent crisis.

Members of the committee should look skeptically at assertions that a 10 percent capital requirement will have a serious adverse impact on the housing recovery -- and even more skeptically at suggestions that this amount of capital is simply not available to finance housing. To be sure, a steeper capital requirement will translate into higher interest rates, but the impact should not be overstated. Recent analysis by Mark Zandi quantifies the impact of recapitalizing the housing finance system under a structure such as that envisioned in S.1217, and puts the interest rate impact at just above 50 basis points for the average borrower. In a normal economic environment, the Federal Reserve can shift interest rates by 50 basis points or more over the course of a two day FOMC meeting. And of course the Fed would be watching the impact of any increase in rates on the housing market and the overall economy and presumably would use monetary policy to help lessen the macroeconomic impact. Moreover, Mr. Zandi’s analysis so far has assumed that the 10 percent first-loss private capital has a uniform structure--that it is entirely common equity. Allowing for this private capital to be tranched, as envisioned in S.1217, would result in lower estimates of the impact on mortgage interest rates.

To be sure, the mortgage interest rate impact is not zero, and will come on top of eventual interest rate increases when the Federal Reserve finally normalizes monetary policy. But affordability remains strong and the housing recovery will continue even with higher rates--indeed, moving forward with housing finance reform that spurs a return of private capital will lessen the barriers now faced by too many borrowers in obtaining access to mortgage financing.

In evaluating the incremental impact of the 10 percent capital requirement over a smaller one such as 5 percent, it is important to keep in mind that the private capital ahead of the government can be split into tranches. Investors will receive a higher return to take on the first loss position at the bottom of the capital stack, reflecting the fact that the risk of the first 5 percentage points of housing credit risk is greater than that of supplying the fifth to tenth percentage points of private capital.

The incremental cost of capital and the degree to which taxpayers are protected by the capital go together. If 5 percent capital is a safe amount to protect taxpayers, then this means that the incremental cost of going from 5 percent capital to 10 percent will be modest—after all, the capital position from the fifth percentage point to the tenth point is quite safe. Putting it more starkly, an assertion that the incremental cost of going from five percent to ten percent capital is not modest should be taken as a signal that 5 percent is not an adequate capital requirement to protect taxpayers. It is not possible to have it both ways -- to say that 5 percent is safe but that 10 percent is costly.

This is of course the usual implication of the renowned Modigliani-Miller theorem, but this is not an academic or theoretical statement. For sure there is a cost from higher capital, since the Modigliani-Miller conditions do not hold in practice—in particular, the tax code with its double-tax on the return from capital provides an incentive for the use of debt finance over equity. But members of Congress should look skeptically at those who deny that incremental capital will have a modest cost impact, especially if such claims are accompanied by noxious assertions about the supposed difference between "academia" and the "real world." There are costs of additional capital, but these are too readily exaggerated.

A related issue is the claim that there is simply not enough capital available to fund housing with a 10 percent capital requirement. This is equivalent to saying that the yield required to attract 10 percent capital is unimaginably high--that capital will not take on housing credit risk regardless of the rewards. This assertion is hard to take seriously in an era in which monetary policy has driven down long term interest rates and spurred a search for yield.

At the same time, the capital requirement should not instantly change from the current situation of zero up to 10 percent—there should be a transition period during which private investors become comfortable with the mechanisms by which they take on housing risk and the attendant markets for housing credit risk become more liquid.

The amount of capital involved in a 10 percent capital requirement should be viewed in context. In round numbers, total U.S. financial market assets are on the order of $50 trillion, split roughly equally between equity and fixed income securities. Housing finance is about $10 trillion of this (with the value of the housing stock roughly twice as large). If eventually housing finance reform results in a system in which half of mortgages are guaranteed and half are not, this means that a 10 percent capital requirement needs about $250 billion more in capital than one with a 5 percent capital requirement. This additional $250 billion is a one percentage point shift from fixed income securities into equity. By further way of comparison, banks and the GSEs together raised around $400 billion in capital in 2007 and 2008 in the face of mounting mortgage losses. We have all learned over the past five years that a safer financial system requires more capital—if anything, the higher mortgage interest rates reflect the fact that the financial system was previously undercapitalized. Higher rates correspond to increased protection for taxpayers.

Diverse sources of funding from a 10 percent capital requirement

A 10 percent capital requirement will both protect taxpayers and provide appropriate incentives for diverse sources of funding for mortgages (in addition to the incentive for prudent behavior by those with capital at risk). Starting from the situation of today in which 90 percent of mortgages have government backing, it would be desirable to have more lending done without a government guarantee so that private investors can finance those who fall outside the government-backed programs. This would include both balance sheet lending and non-guaranteed private label securitization.

While non-guaranteed MBS played an important role in the run-up to the financial crisis, the regulatory regime has changed, including through the advent of the Consumer Financial Protection Bureau (CFPB) to address behavior by non-bank originators. With this in mind, a revival of private label securitization is a desirable policy outcome, to end up with a mortgage market with many sources of capital and a greater share of housing market risk borne by private investors rather than taxpayers. Ultimately it should be seen as a policy success to have some mortgages that could receive a guarantee choose not to obtain one. I recognize the concerns that poor lending practices will reemerge with the private label market but see the regulatory apparatus, including the CFPB, as the right way to address this issue. The alternative would be to have the vast majority of mortgage loans receive a government guarantee as is the case today, with the attendant current downside of the restricted access to financing for too many potential borrowers. It is better to allow private providers of capital rather than the government to fund incremental borrowers, including by having private providers of capital figure out which risks to take on, and reap both the rewards from these investments and the consequences when loans go bad.

A related concern over a revival of private label securitization is that government policymakers will feel obligated to carry out an ex-post bailout in the next crisis. I believe the experience of the financial crisis shows that this is not correct in that the policy focus in the crisis was on ensuring the flow of new financing--that was a paramount reason why Fannie and Freddie were bailed out. Similarly, the TALF program was set up by the Treasury and Federal Reserve to ensure the flow of new securitization to support lending and economy activity and did not provide an ex-post bailout to legacy assets. These considerations likewise argue against an expansion of government guarantees more broadly than housing to other securitized assets such as by setting up a permanent TALF. I see an implicit guarantee as inevitable in housing and thus prefer to make it explicit and priced. But this is the not the case for other securitized lending.

A government guarantee gives rise to adverse selection, as originators seek to obtain a guarantee on risky loans. This is a concern for any plan with a guarantee, regardless of the capital requirement--this applies just as well to a system with a 5 percent capital requirement as it does to one with a 10 percent requirement. If anything, the concern over adverse selection highlights the importance of the housing finance regulator, whether FHFA or FMIC, ensuring that origination standards remain high for loans to be eligible for a guarantee and that the private capital standing in front of the government is able to absorb losses when needed.

Still, it is the case that setting the capital requirement at 10 percent when banks have a 4 percent capital requirement for mortgages held in portfolio provides an incentive to have some loans stay on balance sheet and others go into guaranteed securitization. But again, this same concern applies even if the MBS capital requirement is the same 4 percent as for depository institutions under the Basel standards--once a guarantee is available, originators will have an incentive to obtain a guarantee on their riskiest loans.

Moreover, while banks have a capital requirement of 4 percent for mortgage assets under the Basel framework, they face a broad suite of regulation that does not apply to securitization outside of insured depository institutions, including the threat of prompt corrective action when things go bad, deposit insurance premiums, and a capital surcharge and enhanced liquidity requirements for large banks. Adjusting for these factors means that equivalent capital requirement to compare balance sheet lending to securitization is probably more like five or six percent rather than the simple four percent Basel capital charge. The disparity between the 10 percent capital requirement for guaranteed MBS is thus smaller than it seems. And again, it should be extraordinary for any financial sector activity to receive an explicit government guarantee. An elevated capital requirement is appropriate in this circumstance. An incentive for balance sheet lending and non-guaranteed securitization is welcome, not problematic.

I further suggest that housing finance reform legislation include a mandated minimum capital requirement -- again with 10 percent as an appropriate figure -- rather than allowing regulators to determine this crucial figure. Experience and expectation suggest that political pressures will push regulators in the direction of less capital. This should be avoided. The housing finance regulator is still left with the vital task of ensuring that the capital is high-quality and able to absorb losses. But with the capital requirement representing the bedrock foundation on which protection for taxpayers rests, it would be desirable to have this specified in the legislation.

Activation of the Guarantee

As in the Housing Finance Reform and Taxpayer Protection Act (S. 1217), I would have the secondary government guarantee kick in only after the entire private capital of the entities taking the first loss position at the MBS level. The government would then cover the full principal and interest of the guaranteed MBS. Such an arrangement would ensure that an event in which the government pays out on the guarantee is both rare and consequential.

Private capital at the MBS level could include the equity of the private firm that undertakes the securitization as well as capital that shares the risk such as through credit-linked notes and other structures. The 10 percent capital requirement in this setup would require the securitizer to gather private capital equal to 10 percent of all of the guaranteed MBS it creates. The entire capital required for all guaranteed MBS from a firm would be on the line before the government pays on any MBS. This ensures that the guarantee will rarely activate and that the government will not have to write checks on individual MBS or even multiple MBS that go bad within a particular vintage of origination.

Activation of the guarantee would then be associated with the failure of the private guarantor that has arranged the first loss capital. This is appropriate to ensure that the investors and management involved with the private guarantor suffer the full consequences of failure: shareholders go to zero, management is replaced, and the full losses are imposed on other investors who have taken on housing credit risk. These consequences are attenuated in alternative approaches in which the government guarantee applies to only a vintage of origination at a time. In such a setup, less capital is in front of any one vintage meaning that the guarantee will activate more frequently. With a cooperative structure that persists over time, the management and shareholder/participants of the cooperative likewise do not suffer the full consequences of failure--the cooperative continues and shareholders and management remain.

Adjusting the capital requirement

Provisions to adjust the amount of first-loss private capital would be useful to adapt to temporary circumstances in which the willingness of private investors to supply capital for housing recedes in the face of market uncertainties. Such a mechanism should have safeguards, however, so that it is used infrequently. Policymakers should not seek to ensure that homeowners can obtain low interest rate loans at all times, and should not look to make frequent adjustments to the settings of the housing finance system for the purposes of macroeconomic stabilization. Instead, the Federal Reserve should have the primary responsibility for macro stabilization policy, with changes to housing finance used only when the Fed is not able to achieve its dual objectives.

To ensure this separation between housing finance and macroeconomic stabilization, the director of the housing finance regulator should not have the authority to adjust the required amount of capital. This should be left instead to a joint decision of the Fed Chair and Treasury Secretary, along the lines of the revised Fed authorities under exigent circumstances. As in S.1217, it is appropriate to ensure that any reduction in the capital requirement be explicitly temporary and subject to a limited number of renewals by another decision of those two officials. Such a limited timeframe for renewal of a reduced capital requirement is useful to ensure that the minimum capital requirement is not subverted. A crisis lasting longer than 12 or 18 months -- one or two renewals of the initial 6-month authorization for a reduced capital standard -- is appropriately addressed by legislation rather than regulatory initiatives.

Market structure for guaranteed securitization

The approach taken in S.1217 would arrive at a housing finance system in which multiple firms compete in the business of securitization and guarantee, gathering the required private capital and purchasing the secondary government guarantee. As noted above, such a system would involve competitive pressures that pass on the benefits of any inadvertent government subsidy from under pricing of the secondary insurance to homeowners through lower interest rates. Multiple firms would likewise help address the too big to fail problem by ensuring that one or more could fail without impairing the flow of mortgage financing.

A key requirement for such a system is that sufficient firms are willing to enter into the business of securitization, gathering the private capital and purchasing the secondary government guarantee. S.1217 appropriately looks to jumpstart the process of entry and competition by making all of the infrastructure of the existing GSE's licensable to approved issuers of guaranteed MBS (this infrastructure is the property of Fannie and Freddie, which remain private firms, and thus would be obtained for compensation). Among the new entrants would be a mutually owned firm to ensure that smaller banks have access to the secondary government guarantee without having to go through one of the large banks that today dominate mortgage origination (a single securitization cooperative inevitably would be dominated by large banks). This step of licensing infrastructure would considerably reduce the start up costs for new entrants. Similarly, the requirement that all guaranteed MBS trade on a common securitization platform would ensure that new entrants have the benefits of the full market liquidity. This would avoid a situation in which the securities of a new entrant trade with a considerable liquidity penalty over those of incumbents. The housing finance regulator would likewise be tasked with looking out for anti-competitive practices, including such as the past use of volume discounts that tended to lock originators into particular channels for securitization.

The system in S.1217 would require entry by enough firms to ensure competition. It is hard to say how many are required, but at least three and preferably five seems reasonable as a balance between having enough competition and avoiding TBTF concerns, while not dissipating the natural scale economies involved in housing finance. A variety of firms might be expected to enter into the business of securitization and guaranty, starting with entities that now take on housing credit risks--both investors such as asset managers and private equity funds, and originators such as banks. As noted above, an essential part of housing finance reform is to ensure that smaller institutions have access to any secondary government guarantee without the need to rely on the existing large banks.

Looking ahead, the government eventually could ensure the return of non-guaranteed lending by auctioning off a limited amount of insurance capacity for the government guaranty. The balance of mortgages would then go into the various forms of non-guaranteed lending. Such a system would further help ensure that the risk taken on by taxpayers through providing the secondary government guarantee is appropriately priced in an auction setting.

Conclusion

A housing finance reform that creates an explicit guarantee is appropriate with considerable protection for taxpayers in the form of first-loss private capital, but should be seen as an extraordinary ongoing intervention of the government in the market. In allowing for a guarantee, it is vital to avoid having housing finance reform recreate other aspects of the previous system that failed so badly and imposed immense costs on taxpayers. This would include ensuring that the retained investment portfolios are not allowed for firms with access to the guarantee, and avoiding recreating the previous housing goals that distorted behavior (though the goals were not a primary driving factor behind the collapse of the two GSEs). Any subsidies for affordable housing activities should be done through explicit expenditures and not through housing goals or by imposing duties to serve various populations on firms participating in the housing finance system.

A new housing finance system will be beneficial for individual homeowners by providing new channels through which borrowers can obtain mortgage funding, while providing benefits of greater protection for taxpayers and increased stability for the overall economy. An appropriately designed government guarantee can be an element of such a new system.