Testimony of

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"Returning Private Capital to Mortgage Markets: A Fundamental for Housing Finance Reform"

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Chairman Tester, Ranking Member Johanns, and Members of the Committee, thank you for the opportunity to testify on the vital topic of returning private capital to mortgage markets. 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.

Bringing private capital back to fund mortgages and take on credit risk is an essential element of housing finance reform, particularly with respect to reform of the government-sponsored enterprises (GSEs) of Fannie Mae and Freddie Mac. Housing finance reform should ensure that mortgages are available across economic conditions, while shielding taxpayers from taking on uncompensated risk and protecting the broader economy from the systemic risks that arose in the previous system. Bringing about increased private capital as part of housing finance reform will help protect taxpayers and improve incentives for prudent mortgage origination by lenders and investors with their own resources at risk.

The situation in housing finance today is that taxpayers fund or guarantee more than 90 percent of new mortgages through the GSEs and through government agencies such as the Federal Housing administration (FHA). Fannie Mae and Freddie Mac stand behind virtually all new conforming mortgages through the two firms' guarantees on the mortgage-backed securities (MBS) into which the two firms bundle the home loans they purchase from originators. There is loan-level capital to absorb losses in the form of homeowner down payments and private mortgage insurance (PMI), but no private capital at the level of the mortgage-backed security (MBS) ahead of the financial resources of Fannie and Freddie. With the U.S. Treasury committed to ensuring that Fannie and Freddie remain solvent, the U.S. government effectively backstops conforming loans, leaving taxpayers exposed to considerable losses in the event of another housing downturn—and this risk remains even while the two firms are now profitable. Taxpayers further take on credit risk in housing through the government backstop on the Federal Home Loan Bank (FHLB) system, and through guaranteed mortgages supported by the Federal Housing Administration (FHA) and other federal agencies. I have previously testified on reforms to the FHA that would better protect taxpayers while focusing the agency on its mission to expand access to mortgage financing for low- and moderate income families who have the financial wherewithal to become homeowners.[1] I thus focus here on GSE reform.

Bringing back private capital into housing finance would mean that private investors would absorb losses as some mortgage loans inevitably are not repaid. In some instances, this could involve mortgage loans with no government guarantee, while in others there could be a secondary government guarantee that kicks in only after private capital absorbs losses (or the guarantee could be alongside private capital, with losses shared). Private investors would be compensated for taking on housing credit risk, so that it should be expected that mortgage interest rates will increase as housing finance reform proceeds. This interest rate impact reflects the facts that the previous system was undercapitalized and provided inadequate protection for taxpayers.

It would be useful for reform to allow for a diversity of sources of funding for housing, and for private capital to come in a number of forms and through a variety of mechanisms. This will help make the future housing finance system more resilient to economic and market events that affect particular parts of financial markets and thus impinge on the availability of funds for housing.

At the level of the individual loan, capital for conforming mortgages will continue to be present from a combination of homeowner down payments, private mortgage insurance, and the capital of originators that carry out balance sheet lending. The recent housing bubble and foreclosure crisis highlighted the importance of homeowner equity as a factor in avoiding foreclosures, as foreclosure rates were especially elevated for underwater borrowers—those who owed more on their mortgages than the value of their home. As reform proceeds, it is vital to ensure that meaningful down payments remain a central aspect of underwriting and a requirement for mortgages to qualify for inclusion in MBS that benefit from a government guarantee. Similarly, regulators must ensure that private mortgage insurers have adequate levels of their own high-quality capital to participate in mortgages that receive a government guarantee.

The larger changes involved with the return of private capital to mortgage origination will come at the level of the mortgage-backed security. With nearly all securitization of conforming mortgages going through the GSEs, there is essentially no capital at the MBS level. The so-called profit sweep agreement between the Treasury Department and the two GSEs prevents Fannie and Freddie from building up the capital that would be the norm for an insurer.

Fannie and Freddie are setting up risk-sharing mechanisms to allow private investors to invest in securities that will take losses ahead of the firms' guarantee (that is, ahead of the taxpayer guarantee). There is still little securitization of mortgages taking place without a guarantee (private label securitization of non-conforming loans), and firms other than Fannie and Freddie are not allowed to compete in the business of securitization of conforming mortgages with a government guarantee.

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[1] February 28, 2013, Senate Banking Committee hearing on "Addressing FHA's Financial Condition and Program Challenges, Part II."
http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=6283a07f-b4c3-448a-82e0-d62cfb06bf61

Housing finance reform should involve changes on all of these dimensions so that private capital is present at the MBs-level. These changes are discussed next.

Risk-sharing by Fannie and Freddie on guaranteed single-family MBS

Risk-sharing could be implemented by having the two firms sell non-guaranteed tranches of MBS that take losses either before or at the same time as MBS tranches that receive the guarantee. This could be seen as selling off subordinated tranches of guaranteed MBS. This would be an incremental approach for bringing in private capital that could proceed ahead of legislative action; indeed, work on this is under way at both Fannie and Freddie as part of the FHFA strategic plan. Fannie and Freddie both already share risk in different ways on their MBS for multi-family properties so there are extant examples of such a mechanism.

Risk-sharing would translate into higher mortgage interest rates. The yields on these non-guaranteed tranches would be higher than on securities with a guarantee—after all, investors will demand to be compensated for taking on housing credit risk. Even so, these securities would still be protected from losses by post-crisis underwriting standards (which some would say are too careful), and by homeowner down payments plus any PMI. The interest rates on mortgages facing homeowners would reflect a blend of the yields on the guaranteed and non-guaranteed MBS, along with costs such as the fee (g-fee) paid to the government for taxpayer backing.

An important consideration as risk-sharing proceeds is that the initial volume of non-guaranteed MBS likely would be modest. Yields on the non-guaranteed tranches could thus be elevated by a liquidity premium (that is, by investors' demands to be compensated for the lack of liquidity in these new securities). It would be useful to spread any interest rate impact across mortgages that are bundled into all conforming securities until the risk-sharing program has proceeded enough to provide a liquid market for the non-guaranteed MBS tranches—or more likely, until all guaranteed MBS are protected by first-loss tranches.

As envisioned in the FHFA strategic plan, selling subordinated tranches of guaranteed MBS would allow for a return of private capital to conforming MBS even before housing finance reform clarifies the long-term status of the GSEs. A larger role for the private sector and a receding government guarantee could be brought about by increasing the size of the subordinated tranches and thus providing more first-loss protection ahead of the firms (and thus ahead of the need for the government to make good on its contractual obligation to keep the firms solvent). Note as well that the appropriate guarantee fee to charge on the senior MBS would eventually decrease as more private capital takes losses ahead of the government.

Capital brought in by firms that compete in conforming securitization

A fruitful avenue for housing finance reform would be to allow other firms to compete with Fannie and Freddie in the securitization of conforming MBS. Firms undertaking such securitization would be required to maintain appropriate levels of capital, both their own and that of other investors, to take losses ahead of the government. All firms would then pay for the government guarantee that is secondary to considerable private capital.

Allowing for such competition would be beneficial to ensure that any inadvertent (but likely unavoidable) underpricing of the government guarantee is pushed through to homeowners in the form of lower interest rates rather than allowing MBS securitizers to profit from an elevated spread between (low) interest rates on MBS and (high) interest rates on mortgages. Indeed, Scharfstein and Sunderam (2013) document that a lack of competition results in just such an elevated interest rate spread, to the detriment of potential borrowers.[2]

Fostering competition would further help address the problem that Fannie and Freddie are too important to be allowed to fail. If enough additional firms enter in the business of mortgage securitization, then any such securitizer could fail while others continue to undertake securitization. Entry and competition as part of housing finance reform could thus help to avoid a situation in which mortgage financing is not available to American homeowners, with potentially serious negative impacts on the U.S. economy.

Two steps are vital to allow for entry and competition. The first is the completion of the common securitization platform now being developed jointly by Fannie and Freddie as part of the FHFA strategic plan. A common securitization platform would unify the markets for MBS packaged by the two GSEs—both are effectively guaranteed, but they trade separately to the disadvantage of the less liquid Freddie Mac securities. A common securitization platform would facilitate entry by new firms that securitize guaranteed MBS in competition with Fannie and Freddie, since the MBS of new entrants could trade in the same market as MBS issued by Fannie and Freddie rather than trading separately and facing a considerable liquidity disadvantage. In developing the common securitization platform, it will be important to maintain the TBA ("To Be Arranged") market that facilitates desirable features of such as the ability of homeowners to lock in interest rates.

The second step would be for the government guarantee that now backstops Fannie and Freddie as firms to switch instead to a guarantee on qualifying MBS (rather than on the firms themselves). This step requires Congressional action, since it would formalize the government guarantee on housing that is now merely a bilateral contract between the Treasury and each GSE. The government guarantee on housing would be formalized, but only so that the guarantee could shrink by requiring increased first-loss private capital before the guarantee. In other words, the guarantee would be made explicit so that it could recede.

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[2] See David Scharfstein and Adi Sunderam, "Concentration in Mortgage Lending, Refinancing Activity, and Mortgage Rates," April 2013. http://www.hbs.edu/faculty/Publication%20Files/Concentration_in_Mortgage_Lending_20130407_adfb023e-3c76-42df-9ede-312925dae538.pdf

Housing finance reform must ensure that smaller financial institutions have access to the housing finance system on terms equal to those for the larger firms that dominate mortgage origination. The reform discussed here meets this essential criterion in two ways. The first is that the use of a common securitization platform would allow regulators to enforce non-discrimination provisions that require firms that obtain the secondary government guarantee for their MBS to purchase qualifying mortgage loans on equal terms from qualifying lenders. That is, regulators would ensure that the system is open to all conforming loans. At the same time, it would be natural for smaller institutions to join together to form a securitizer on a mutual basis. As an observation, the securitization and guaranty businesses of Fannie Mae and Freddie Mac are generating substantial profits, reportedly on the order of $20 billion per year combined between the two firms. Forming a mutual securitization company would thus give smaller institutions a share of these profits while ensuring that they do not need to rely on larger firms for access to the housing finance system.

Firms competing in securitization of conforming MBS could have several forms of private capital ahead of the secondary government guarantee, including both their own equity and capital arranged with other private entities. For example, securitizing firms might purchase MBS-level insurance from other private firms, much as individual homeowners purchase private mortgage insurance. As with any such insurance product, a key consideration is to ensure that the firms providing MBS insurance maintain appropriate amounts of high-quality capital.

An alternative to MBS insurance would be for MBS securitizers to issue credit-linked securities in which private investors provide funds to the securitizer in return for a yield (as usual with a fixed income security), with provisions that specify the losses to be apportioned to the outside investors in the event of housing credit losses. Such credit-linked securities would bring in private capital in a similar fashion to the subordinated tranches of MBS discussed above.

The market for conforming MBS would thus include securities with and without a government guarantee. The common securitization platform would again be important to ensure that the guaranteed securities trade together in a liquid market for all issuers. The non-guaranteed MBS tranches could then trade separately for each securitizer. Indeed, investors willing to take on first-loss housing credit risk would be expected to demand considerable information on the characteristics of the mortgages in the MBS. A useful feature of the structure discussed here is that the amount and high quality of the private capital is clear—the non-guaranteed securities take losses up to the amount of capital at risk.

<u>Private label securitization</u>

An increase in mortgage lending without a government guarantee would constitute a direct return of private capital to housing finance. Housing finance reform along the lines of the process discussed above would gradually increase the incentive for some mortgages that could qualify for a government guarantee to choose to go without one. The increased incentive to avoid the government guarantee would reflect the costs that correspond to a requirement for an increasing amount of first-loss private capital (risk-sharing), along with a higher fee charged by the government for the secondary guarantee on conforming MBS. As an increasing amount of first-loss capital is required ahead of the government guarantee and as the g-fee insurance premium rises, so too will the incentives rise for a larger-scale restart of private label securitization. At some point, if enough private capital is required and the g-fee pricing is set high enough, some conforming loans that qualify for the guarantee will choose not to purchase it and prefer instead to arrange for non-guaranteed financing. This could include securitization of non-guaranteed (private label) conforming MBS.

If the government no longer provides a guarantee for every conforming mortgage, then an auction mechanism could be used to set the price of the government insurance. This would help to address the difficult challenge of setting the price for the guarantee. One way to achieve this outcome in which not all conforming mortgages are covered by a guarantee would be to gradually reduce the amount of insurance capacity offered by the government. A safety valve mechanism could be put in place under which the government would offer additional insurance capacity at a higher guarantee premium that market participants would find unattractive in normal times and thus prefer to arrange for private-label securitization but remain available in the event of a future crisis in which funding for non-guaranteed securitization dries up (as has been the case since the collapse of the housing bubble in 2006).

Steps that make guaranteed MBS less attractive would similarly boost the incentives for increased usage of private label securitization of non-conforming loans—mortgages that do not qualify for the government guarantee. This is because as costs for (conforming) guaranteed loans increase, some borrowers who might have taken out a conforming loan will instead turn to mortgages with non-conforming features such as a principal amount above the conforming loan limit. Even so, a broad restart of non-guaranteed securitization likely requires further progress in reducing the uncertainties regarding the regulatory environment and legal liability for loans that do not qualify for the safe harbor in the CFPB's qualified mortgage (QM) standard. Private label MBS issuance was $4.2 billion in 2012 according to data collected by SIFMA (the Securities Industry and Financial Markets Association)—compared to more than $1 trillion in MBS issuance covered by a government guarantee.

## Policy Levers to Foster a Return of Private Capital into Housing Finance

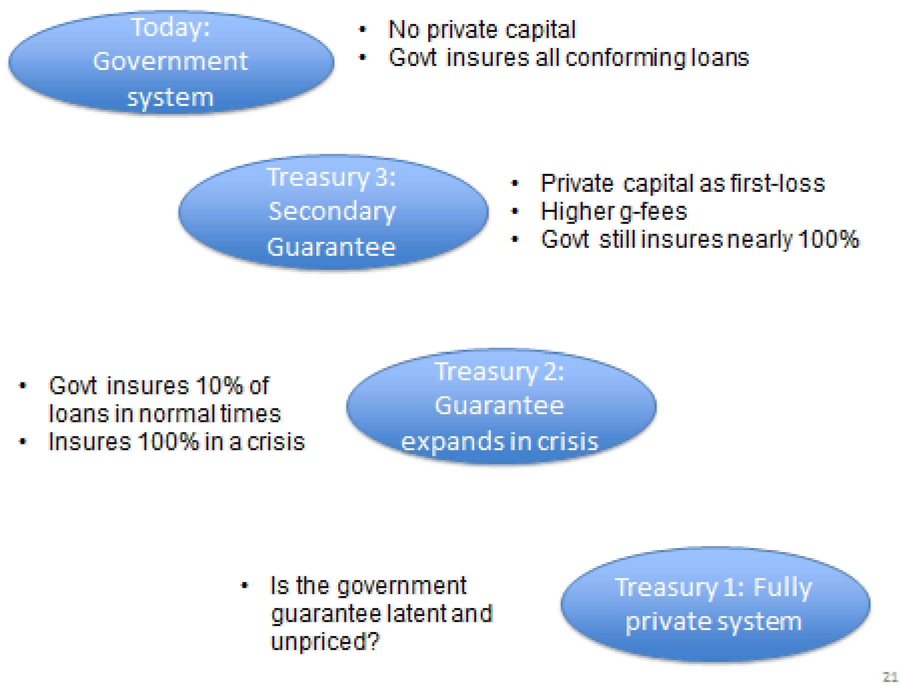
The various channels through which private capital could return to the housing finance system involve four main policy levers: 1) raising the price of the government guarantee; 2) reducing the quantity of insurance offered by the government or otherwise narrowing the scope of mortgages eligible for the government insurance; 3) opening the housing finance system to new competition that brings in private capital; and 4) requiring firms that securitize government-insured MBS to arrange for first-loss private capital to take losses before the government guarantee.

Reducing or eliminating the government role in housing finance involves going further with these four policy levers. The jumping-off point for reform is the current system in which there is no first-loss private capital and taxpayers stand behind essentially all conforming loans. It is instructive to consider the steps to move to a private system in which there is no government guarantee on conforming mortgages (leaving aside the FHA and other smaller programs). To reach a private outcome, the housing finance system will first transit through the alternative in which there is a secondary government guarantee behind first-loss private capital at the MBS level but all conforming mortgages continue to be insured by the government (which now provides a secondary guarantee). This first alternative is precisely option three from the February 2011 Treasury-HUD White Paper on "Reforming America's Housing Finance Market." That is, Treasury-HUD option three is a necessary first step in the move toward a private housing finance system.

Moving further toward a private system from Treasury-HUD option three involves additional increases in guarantee fees and a requirement for yet greater first-loss private capital ahead of the secondary government guarantee. As these policy levers are utilized, eventually only a modest share of mortgages will be included in MBS that receive the secondary government guarantee. Instead, most mortgages will be funded privately, at least in normal times. In times of credit market stress, a greater share of mortgages would avail themselves of the government guarantee, even at the cost of the higher g-fees and increased private capital. This outcome is precisely option two from the 2011 Treasury-HUD White Paper. Again, the second option in the Treasury-HUD white paper is a necessary stage on the transition to a private system.

Eventually as the policy levers are fully utilized, the pricing of the guarantee fee will be so high that no MBS securitizers will purchase the government guarantee (or more simply, the amount of first-loss private capital required in front of the guarantee is set at 100 percent, eliminating the guarantee). This outcome is option one in the 2011 Treasury-HUD White Paper.

In other words, ending up at a housing finance system that is fully private involves a transition through intermediate steps in which there is first private capital in front of a secondary government guarantee (Treasury-HUD option three) and then a stage in which the share of guaranteed MBS declines and the share of private label securitization and non-guaranteed balance sheet lending increases (Treasury-HUD option two). Rather than seeing the three options in the Treasury-HUD White Paper as separate proposals, it is useful to note that they differ by the settings of the policy levers of the price and quantity of the government backstop, the scope of conforming mortgages, and the amount of required private capital. These levers in turn determine the share of conforming mortgages that will be covered by the government insurance and thus the choice between the three Treasury options. In other words, the seemingly distinct policy options often considered in the debate over housing finance reform are better seen as points on a spectrum that differ by the share of credit risk taken on by the government and by private investors. This approach is depicted in the figure below.




Moving forward with Housing Finance Reform that brings back private capital

The key question in housing finance reform remains the degree of government involvement, and especially whether there should be some form of a government guarantee on some housing credit risk, even if one that takes effect only after private investors take losses first. I have written previously that I see it as a political and social reality that future U.S. governments will intervene if potential homebuyers cannot obtain mortgage financing such as during a financial crisis.[3] An implication is that a housing finance system that is notionally fully private will inadvertently recreate the implicit guarantee in the previous system that failed so badly and that left taxpayers with a costly bailout. It would be better in my view for the inevitable government involvement to be made explicit. Taxpayers would be compensated for taking on housing risk, with considerable private capital ahead of the secondary government guarantee.

Housing finance reform that brings back private capital can proceed without resolving the question over the eventual role of the housing finance system. This is because the policy levers required to move forward with reform are the same ones to reach any system with a smaller role for the government than today, including the system with a secondary government guarantee and the alternative in which there is no role for the government (at least no explicit role). Indeed, as noted above, to reach the system with no government guarantee, a partial guarantee will be in place during a transition.

[3] Phillip Swagel, 2012. "The Future of Housing Finance Reform." *The B.E. Journal of Macroeconomics*, volume 12 issue 3, article 11.

Whether it is possible for housing finance reform to arrive at a system that is fully private (at least notionally) will depend on the societal and political reaction to the higher mortgage interest rates and reduced availability of credit that correspond to the increased protection for taxpayers from a system with a greater role for private capital. It is unclear whether a private housing finance system is politically and socially feasible. But the way to find out is to start by adjusting the policy levers that bring in private capital.

This implies that (the sometimes passionate) disagreements about the role of the government at the core of the policy debate over U.S. housing finance reform are misplaced. The next steps are the same for all plans now under serious consideration; namely, that the price the government charges to insure mortgages should rise, the volume and scope of mortgages that the government offers to insure should decline, and the amount of private capital should increase.

The disagreement is over how far to turn the policy levers affecting the price and quantity of the government insurance, and how that in turn will affect the interest rates and types of mortgage products faced by American homebuyers. How far to go toward a private system will ultimately reflect a societal and political judgment about the role of homeownership and the degree to which Americans support public efforts to foster homeownership.

The alternative is to wait for reform until there is agreement over the end point. Waiting to start with housing finance reform is a choice in itself—to keep Fannie Mae and Freddie Mac in government control and to have little role for private capital. The longer that conservatorship continues, the more likely it is that it becomes permanent, with Fannie Mae and Freddie Mac in government hands forever. This would mean a long-run housing finance system that most acutely puts taxpayers at risk while missing out on the possibilities for innovation that are most likely to occur with a system driven by private sector involvement and incentives.  Such a nationalized housing finance system is a default outcome if no reform is undertaken.