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Adam J. Levitin
Professor of Law

Written Testimony of

Adam J. Levitin
Professor of Law
Georgetown University Law Center

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"Housing Finance Reform: Should There Be a Government Guarantee?"

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Witness Background Statement

Adam J. Levitin in a Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in bankruptcy, commercial law, consumer finance, contracts, and structured finance. He is also a member of the Center for American Progress's Mortgage Finance Working Group. Professor Levitin has previously served as the Robert Zinman Scholar in Residence at the American Bankruptcy Institute and as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP). Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College, all with honors.

Professor Levitin has not received any Federal grants nor has he received any compensation in connection with his testimony, and is not testifying on behalf of any organization.

Mr. Chairman, Ranking Member Shelby, Members of the Subcommittee:

My name is Adam Levitin, and I am a Professor of Law at the Georgetown University Law Center in Washington, D.C., where I teach courses in structured finance, bankruptcy, and commercial law. I am also a member of the Mortgage Finance Working Group sponsored by the Center for American Progress, which has put forth a proposal for GSE reform. I am here today, however, as an academic who has written extensively on housing finance and am not testifying on behalf of the Mortgage Finance Working Group.

As an initial matter, I want to be clear where I stand ideologically on housing finance reform. In the ideal world, I would unequivocally prefer to see the U.S. housing finance system financed entirely with private capital. The government's involvement in the U.S. housing finance system carries with it serious concerns of moral hazard and politicized underwriting.

I am nonetheless opposed to proposals to eliminate any government guarantee from the housing finance system. My opposition is based on practical realities, not ideological grounds. It is important that we not allow our ideological predilections get in the way of common sense. Despite privatization's ideological appeal, there is a fundamental problem with privatization proposals for the housing finance system: they don't work. Indeed, fully private housing finance systems simply do not exist in the developed world.

Following the siren's song of privatization would put the entire U.S. economy in grave peril, as there is simply nowhere close to the sufficient private risk capital willing to assume credit risk on U.S. mortgages, even prime ones. The housing finance market is barely stabilized with massive government life support; it is no longer on the operating table, but is in the financial equivalent of the intensive care unit. Pulling the plug on the government guarantee will kill the housing market, not resurrect it. Eliminating the government guarantee risks the flight of over $6 trillion dollars from the U.S. housing finance market—roughly half the dollars invested in U.S. mortgages.[1] Such an occurrence would be catastrophic for the U.S. economy.

Along these lines, I wish to make five major points in my testimony:

(1) There is insufficient market demand for U.S. mortgage credit risk to support the U.S. housing market absent some form of government guarantee.

(2) The prime jumbo securitization market does not provide evidence of the viability of a large-scale private securitization market.

(3) All five previous attempts at private mortgage securitization in the United States failed because of the inability of investors to manage credit risk in securitization.

(4) There is no housing finance market anywhere in the developed world in which there is neither an explicit nor an implicit government guarantee of at least catastrophic risk.

(5) The choice we face is not guarantee versus no guarantee. It is between an implicit and an explicit guarantee. A government guarantee is inevitable in the housing finance market, so it is best to make the guarantee explicit and well-structured and priced.

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[1] Federal Reserve Statistical Release Z.1, Table. L.217, June 9, 2011.

[2] Notably some proponents of privatization would have a government regulatory role in the market. It is hard to fathom the government as regulating the market, but taking no responsibility then, if the market collapses.

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I. LACK OF MARKET DEMAND FOR MORTGAGE CREDIT RISK

A mortgage carries two types of risks for investors: credit risk and interest rate risk. Credit risk is the risk that the borrower will default on the mortgage. Interest rate risk is the risk that interest rates will either rise—in which case the interest rate the investor earns on the mortgage will be below market—or that interest rates will fall—in which case the mortgage will now be at an above market rate, but with the borrower likely to refinance.

GSE and Ginnie Mae securitization divides the credit risk from the interest rate risk. Investors in Fannie, Freddie, and Ginnie mortgage-backed securities assume interest rate risk, but not credit risk. The credit risk is retained by Fannie, Freddie, or Ginnie, which often are insured for part or all of that risk, either through private mortgage insurers or through FHA insurance and VA guarantees.

In contrast with the GSEs and Ginnie Mae, investors in private-label mortgage-backed securities (PLS) assume both interest rate risk *and* credit risk. Over 90% of PLS were rated AAA at issuance by credit rating agencies. Investors who relied on these ratings understood the credit risk on these PLS to be negligible because of the quality of the underlying mortgages and various credit enhancements to the PLS, such as senior-subordinate credit structures, overcollateralization, excess spread accounts, and various types of insurance.

What this means is that the overwhelming majority of investors in the U.S. secondary mortgage market are not credit risk investors. Investors in Fannie, Freddie, and Ginnie MBS are not credit risk investors, and most investors in PLS did not perceive themselves as assuming credit risk. Instead, U.S. mortgage investors are interest rate risk investors.

Interest rate risk investors are very different types of investors than credit risk investors. Investing in credit risk successfully requires a different kind of diligence and expertise than interest rate risk investment. A large portion of the investment in U.S. mortgages is from by foreign investors. Chinese investment funds and Norwegian pension plans, for example, are unlikely to seek to assume credit risk on mortgages in a consumer credit market they do not know intimately. But interest rate risk is something that foreign investors are far better positioned to assume because it is highly correlated with expectations about U.S. Federal Reserve discount rates.

Proponents of secondary mortgage market privatization would have the government guarantee completely eliminated, meaning that investors would bear both interest rate risk *and* credit risk.[2] There is no evidence that there is a substantial body of capital eager to assume credit risk on U.S. mortgages *at any rate*, much less at mortgage rates that would not be prohibitively expensive for borrowers. Even if PLS were structured to remove most credit risk from some securities, few investors are likely to trust credit ratings on MBS in the foreseeable future. What all of this means is that if the secondary mortgage market were completely privatized, as much as $6 trillion in housing finance investment—roughly half of the investment in the U.S. housing finance market— would leave the U.S. market. The result would be a collapse on a scale far worse than in 2008.

[2] Notably some proponents of privatization would have a government regulatory role in the market. It is hard to fathom the government as regulating the market, but taking no responsibility then, if the market collapses.

II. THE JUMBO MARKET DOES NOT PROVIDE EVIDENCE OF THE VIABILITY OF A LARGE-SCALE PRIVATE MARKET

Mortgages that are too large to qualify for purchase by the GSEs because of the statutory conforming loan limit are known as "jumbo" mortgages. There is a private securitization market in jumbo mortgages. In the jumbo market, investors assume both interest risk and credit risk. Advocates of privatization have suggested that the existence of the jumbo market is proof that a securitization market can function without a government guarantee.

The existence of the private jumbo mortgage securitization market is does not demonstrate that there is sufficient private risk capital to support the entire U.S. housing market. The jumbo market is smaller and benefits from the existence of the government supported market. The shape of the jumbo market in fact indicates that there is a quite limited demand of credit risk on U.S. mortgages, and certainly not enough to sustain the entire market absent a government guarantee.

The jumbo market overall is substantially smaller than the conforming market. From 2001-2007, there were roughly two times as many dollars of conforming loans originated as jumbo loans, and in sheer origination dollars, the jumbo market has never comprised more than a quarter of the U.S. market.[3] Jumbo loans are more expensive than conforming loans; currently there is around a 60 basis point spread between jumbo and conforming rates, despite jumbos often being of higher credit quality. While some of that spread (which at times has been as small as 20 basis points) is a function of the GSE guarantee, it is also a reflection of limited demand for U.S. jumbo mortgages—meaning a limited demand for credit risk. If all U.S. mortgage investors were willing to assume credit risk, we should tighter credit spreads between prime jumbos and conventional conforming loans, and investors would be willing to assume the credit risk on jumbos for the additional return.

What's more, the securitization rate for jumbo loans is substantially lower, which has resulted in a much smaller amount of jumbo mortgage-backed securities issued than GSE MBS. (See Figures 1 and 2). Jumbos lower securitization rate is itself strong evidence of limited investor demand of credit risk on U.S. mortgages—at least at interest rates less than those borne on subprime loans.

[3] Inside Mortgage Finance, Mortgage Market Statistical Annual.

Figure 1. Securitization Rates for Conventional Conforming and Prime Jumbo Loans

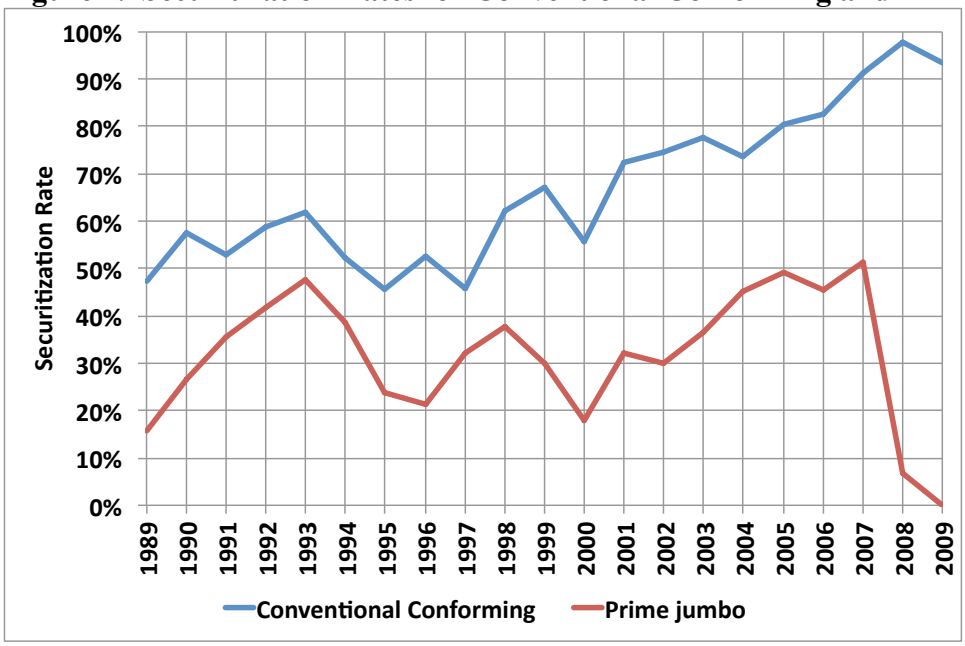
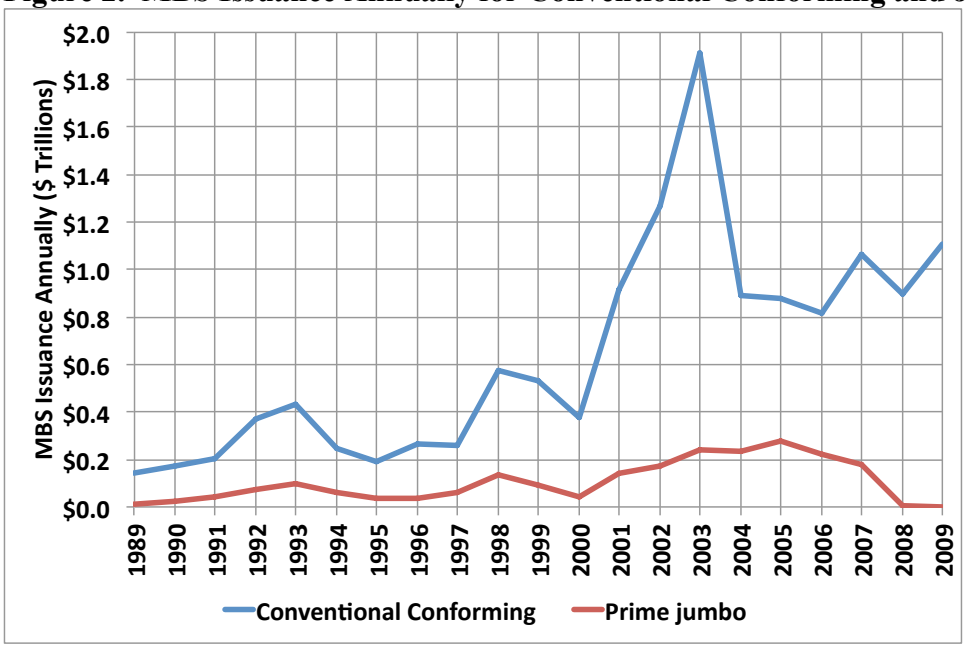


Figure 2. MBS Issuance Annually for Conventional Conforming and Jumbo Loans



Proponents of privatization also ignore that the jumbo market does benefit from a government guarantee indirectly in multiple ways. The jumbo market has long aped the standards set by the GSEs in the conforming market, including amortization, maturity lengths, and appraisal standards. Indeed, the real benefit of the GSEs was not in terms of cost savings through efficiency or the government guarantee but in standard setting; but for the GSEs, the 30-year fixed rate mortgage would likely not exist. The standardization achieved by the conforming market has enabled the jumbo To Be Announced (TBA) market, which lets borrowers lock in their interest rates months before closing. The jumbo TBA market piggybacks on the existence

of the highly liquid conforming TBA market. Whether this would continue absent a government guaranteed TBA market is questionable.

Finally, the stability of housing prices in the jumbo market benefits from the government guarantee in the conforming market. Housing prices of nearby properties are highly correlated. The ability for buyers or owners to obtain financing or refinancing significantly affects property values, so to the extent that the government guarantee has stabilized the conforming market and thus bolstered the property values of properties with conforming mortgages, there is a spill-over that benefits properties with jumbo mortgages. The systemic stability that comes from the government guarantee has benefitted the jumbo market. Indeed, the virtual disappearance of the jumbo market following the financial collapse in 2008 draws into question whether this market is in fact viable; the spill-over benefits from the guarantee in the conforming market have not been enough to resuscitate the jumbo market.

The jumbo market demonstrates that there are *some* investors who are willing to assume credit risk on U.S. mortgages. But investors in the vast majority of the $6 trillion plus in U.S. mortgage securities outstanding are interest rate investors, and it is difficult to imagine them transforming into credit risk investors over several years, much less immediately. Sufficiently high yields will no doubt lure some of them into accepting credit risk—but that translates into much higher mortgage interest rates, which in turn increases the credit risk on the mortgages. And even higher yields will not be sufficient to induce investors who have no interest in assuming credit risk to buy into the U.S. mortgage market. The fundamental problem with any housing finance privatization proposal is that there just isn't sufficient capital interested in credit risk on U.S. mortgages. Ideology cannot substitute for market demand.

III. WE'VE TRIED THIS FIVE TIMES BEFORE WITHOUT SUCCESS[4]

Privatization advocates pay little attention to the history of housing finance in the United States, but it holds a cautionary tale. The United States has had four previous experiences with private mortgage securitization. These experiences have been long-forgotten, but it is important to note that every time ended in disaster, as did the fifth experiment, that of private label mortgage securitization in the 2000s. There is little reason to believe that a sixth charge of the Light Brigade will be more successful.

The U.S. did not develop a national secondary mortgage market until the New Deal. By the mid-nineteenth century, however, deep secondary mortgage markets were well-established in both France (the state-chartered joint-stock monopoly *Crédit Foncier*) and the German states (cooperative borrowers' associations called *Landschaften* and private joint-stock banks in Prussia and Bavaria), and "[b]y 1900 the French and German market for mortgage-backed securities was larger than the corporate bond market and comparable in size to markets for government debt."[5] Although there were significant design differences in the European systems, they all operated on a basic principle—securities were issued by dedicated mortgage origination entities. Investors

[4] This section of the testimony derives from Adam J. Levitin & Susan M. Wachter, *The Rise, Fall, and Return of the Public Option in Housing Finance*, in REGULATORY BREAKDOWN? THE CRISIS OF CONFIDENCE IN U.S. REGULATION, Cary Coglianese, ed. (University of Pennsylvania Press, forthcoming 2012).

[5] Kenneth A. Snowden, *Mortgage Securitization in the United States: Twentieth Century Developments in Historical Perspective*, in ANGLO-AMERICAN FINANCIAL SYSTEMS: INSTITUTIONS AND MARKETS IN THE TWENTIETH CENTURY, MICHAEL D. BORDO & RICHARD SYLLA, EDS. 261, 270 (1995).

therefore assumed the credit risk of the origination entities. Because these entities' assets were primarily mortgages, the real credit risk assumed by the investors was that on the mortgages.

The European systems were successful because they ensured that investors perceived them as free of default risk. This was done through two mechanisms. First, there were close links between the mortgage origination entities and the state. Mortgage investors thus believed there to be an implicit state guarantee of payment on the securities they held. Second, and relatedly, the state required heavy regulation of the mortgage market entities, including underwriting standards, overcollateralization of securities, capital requirements, dedicated sinking funds, auditing, and management qualifications.[6]

There were attempts to import the *Crédit Foncier* model to the U.S. in both the 1870s and 1880s. Mortgage companies that originated and serviced the loans, pledging them against "debentures… issued in series backed by specific mortgage pools."[7] These attempts failed as the originators often violated their stated underwriting standards and securitized only the lowest quality collateral.[8]

A third attempt at establishing a private secondary market was undertaken in the 1900s by New York title guarantee companies, which expanded beyond title insurance into mortgage and bond credit insurance.[9] The title companies originated mortgages, insured them, and then sold debt securities backed by the mortgages. The favored form were participation certificates that allocated the cash flow from the underlying mortgage pool in proportionate shares, much like later Fannie Mae/Freddie Mac Pass-Thru Certificates.[10] These participation certificates thus created a secondary market in mortgages. The purchasers of the participation certificates believed that they were assuming the credit risk of the title company that insured the mortgages, rather than the borrower, so they were not particularly concerned with the quality of the mortgage underwriting.

As defaults in the housing market rose in 1928-1934, the guaranteed participation certificate market collapsed. Poor regulation and malfeasance by the title companies made it impossible to weather a market downturn. The title companies were thinly capitalized and routinely violated their underwriting standards, and engaged in assorted other shenanigans that resonate of the excesses of the 2000s market.[11]

In addition to the guaranteed participation certificates, another type of secondary market instrument emerged in the 1920s, the single-property real estate bond. Whereas participation certificates were issued against a pool of mortgages, single-property real estate bonds were backed by a single building, a distinction roughly analogous to that between securitization and project finance. Single-property real estate bonds were used to finance large construction projects, such as the skyscrapers of New York and Chicago.[12] This system too collapsed in a series of scandals in the 1920s and '30s that made clear that underwriting standards had long

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[6] *Id.* at 271-73

[7] *Id.* at 278.

[8] *Id*. at 279.

[9] James Graaskamp, *Development and Structure of Mortgage Loan Guarantee Insurance in the United States*, 34 J. RISK AND INS. 47, 49 (1967).

[10] *Id.* at 49-50; Snowden, *supra* note 5, at 284.

[11] Graaskamp, *supra* note 9, at 51; Snowden, *supra* note 5, at 285.

[12] Snowden, *supra* note 5, at 286.

been ignored. Their enduring legacy of the single-property real estate bonds is the Trust Indenture Act of 1939, the preamble to which is an indictment of the industry's practices.

Finally, in the 2000s we saw an explosive growth of private-label mortgage securitization. PLS great from 21% of MBS issuance in 2003 to 56%—a majority of the market—in 2006. PLS operated in a largely unregulated space and underwriting standards quickly collapsed. The growth in PLS ate away at the GSEs' market share, which encouraged the GSEs to be more aggressive in their underwriting. This competition between the GSEs and the unregulated PLS market proved fatal to the entire financial system.[13]

Early American secondary mortgage markets share two critical commonalities with each other and with the PLS market in the 2000s. First, they were virtually unregulated, and what regulation existed was wholly inadequate to ensuring prudent operations. And second, they all suffered from an inability to maintain underwriting standards, as the loan originators had no capital at risk in the mortgages themselves, regulation was scant, and investors in the mortgage-backed bonds lacked the ability to monitor the origination process or the collateral. In contrast, successful European structures, "were either publicly financed or sponsored and were subject to intense regulatory scrutiny."[14] The historical evidence strongly indicates that both a government guarantee and a robust, market-wide regulatory system is necessary to ensure a stable, liquid secondary market.

IV. All Developed Countries Implicitly or Explicitly Guarantee Their Housing Financed Systems

A truly private housing finance system is a pipedream. It simply does not exist in any developed country and never has. Every developed country either explicitly or implicitly guarantees some part of its housing finance system. In some countries, like Canada, the guarantee is explicit—and priced—and the market is regulated to protect the government from excessive risk exposure. In other countries, the guarantee is implicit. It is difficult to prove an implicit guarantee; the very nature of it is that there is no clear proof. One can look at spreads between mortgage debt and government debt, for example, but that is not necessarily conclusive. Indeed, in the United States, GSE debt was explicitly *not* guaranteed by the federal government…until it was.

Proponents of privatizing the housing finance system and eliminating the government guarantee will generally point to Germany and Denmark as examples of housing finance systems without a guarantee that have widely available long-term, fixed-rate mortgages.[15] Unfortunately, this view of the German and Danish housing finance systems is incorrect. Germany and Denmark both turn out to have been latent implicit guarantee cases prior to October 2010, at which point they became examples of explicit guarantees.

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[13] Regarding the causes of the housing bubble and its collapse, *see* Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEORGETOWN LAW JOURNAL (forthcoming 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1669401.

[14] Snowden, *supra* note 5, at 263.

[15] E.g., Peter J. Wallison, *A New Housing Finance System for the United States*, Mercatus Center Working Paper No. 11-08, *at* http://mercatus.org/sites/default/files/publication/wp1108-a-new-housing-finance-system-for-the-united-states_0.pdf, at 10 ("Neither Denmark nor Germany backs any part of the mortgage financing system, which seems to work well because of the regulatory assurances of mortgage quality.").

In October 2008, Germany created a Teutonic TARP known as the "Special Fund Financial Market Stabilization," or SoFFin (its German acronym) to bail out its banks. SoFFin provided nearly €150 billion to support ten financial institutions' liabilities, including those of one issuer of covered mortgage bonds and of three Landesbanks (another type of German mortgage lender).[16] Germany was not prepared to allow even one of its numerous covered bond issuers to fail, even though any single issuer was arguably not a systemically important financial institution.

Denmark also announced a broad guarantee of all deposits and senior debt issued by its banks in October 2008.[17] Denmark has a robust mortgage lending system financed by covered bonds—bonds issued by banks against mortgage collateral held on balance sheet. Formally, the Danish guarantee did not apply covered bonds, only to the deposits and senior debts of the banks that issued them. The functional reality of this arrangement, however, was to guarantee the covered bonds by guaranteeing that the issuers would have sufficient assets and liquidity to meet their covered bond payment obligations so that the covered bondholders would never have to look to their cover pools of collateral for recovery.

There is no housing finance system in the developed world in which there is neither an implicit nor explicit guarantee, much less one which ensures the wide-spread availability of long-term, fixed-rate mortgages.

V. THE INEVITABILITY OF A GUARANTEE MEANS IT SHOULD BE EXPLICIT AND PRICED

The lack of a formal guarantee in good times is no guarantee against the application of a formal guarantee in bad times. Housing finance is simply too central to the economies of developed countries and to their social stability to permit market collapse. Put differently, there's no way to guarantee against a guarantee.

Therefore, it's better to accept that we are going to be living with a guarantee sooner or later—whenever the next crisis occurs—and to design a system that properly prices for it now. In 2008, the market saw that when threatened with collapse, the U.S. government blinked. And despite Congress's best efforts and Dodd-Frank's no-bailout provisions (which still leave the door open for *sub rosa* bailouts), it's hard to believe that if threatened with massive economic collapse, the U.S. government wouldn't bail out the financial system again. As distasteful as bailouts are, we as a society are simply too scared of the potential consequences of *not* bailing out the system to find out what would happen.

What this means is that if we are really serious about avoiding moral hazard, we actually have to have an explicit guarantee and price for it. Counterintuitively, an explicit and properly priced guarantee is the best protection against moral hazard. Otherwise, we will find ourselves in the next crisis with a private system that is suddenly guaranteed by the government, and which

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[16] *See* Bundesanstalt für Finanzdienstleistunsaufsicht, "Annual Report of the Federal Financial Supervisory Authority" (2008), available at http://www.bafin.de/cln_152/nn_720486/SharedDocs/Downloads/EN/Service/Jahresberichte/2008/annualreport__08__complete,templateId=raw,property=publicationFile.pdf/annualreport_08_complete.pdf.

[17] *See* Neelie Kroes, "Guarantee scheme for banks in Denmark," European Commission Memorandum, State Aid NN51/2008 – Denmark," *available at* http://ec.europa.eu/community_law/state_aids/comp-2008/nn051-08.pdf.

has never had to pay for it, despite everyone in the market knowing that if things get really bad, Uncle Sam will come bail them out.

It is thus important to recognize, however, that the government is not assuming *more* risk with an explicit guarantee. Instead, an explicit guarantee is just formalizing what the market assumes and hopefully pricing for it.

CONCLUSION

Try as we may, we cannot escape either history or the reality that the U.S. government will always bailout its housing finance system if it gets into trouble. We did that in 1932-34. We did it with the S&Ls in the 1980s. We did it again in 2008. Catastrophic risk in housing finance is inevitably socialized, so it is best to recognized that truism and adapt our regulatory system to mitigate the risk. Pretending that is won't happen again is hardly a solution.

We do not have to like the existence of a government guarantee in housing finance. But the choice we face is between an implicit and an explicit guarantee, not between a guarantee and no guarantee. All government guarantees have clear problems—moral hazard because the government holds the credit risk, while private parties hold the upside, and the danger of politicized underwriting. There are ways to try to guard against both problems. For example, moral hazard can be alleviated through use of deductibles and copayments—have first-loss private risk capital or loss splitting between the government and private capital. Administrative structures can guard against politicized underwriting. Those risk mitigants, however, require an explicit guarantee.

For better or worse, though, we need to accept that *some* form of a government guarantee, even if only for catastrophic losses, is required in our housing finance system. The unique nature of housing finance as an enormous asset class that affects a wide swath of citizens and economic and social stability means that no U.S. government will permit the market's collapse: it would be economic and political suicide. The question then is not whether there should be a guarantee—we have one whether we want it or not—but how it should be structured.