"Envisioning a Safe, Sound Mortgage Market for Sustainable Homeownership"

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WRITTEN TESTIMONY OF DR. SUSAN M. WACHTER
Richard B. Worley Professor of Financial Management
Professor of Real Estate and Finance
The Wharton School
University of Pennsylvania

3733 Spruce Street
430 Vance Hall
Philadelphia, PA 19104
215-898-6355
wachter@wharton.upenn.edu

Chairman Dodd, Ranking Member Shelby, and other distinguished members of the Committee:

Thank you for the invitation to testify at today's hearing on the "Future of the Mortgage Market and the Housing Enterprises." It is my honor to be here to discuss the future of the mortgage market in the United States. Historically homeownership for Americans has served as bedrock of social prosperity. Given recent history, we must ask ourselves how to envision a safe, sound mortgage market for sustainable homeownership going forward.

As we consider the future of the mortgage market, we need to step back and understand the sources of the global financial debacle. Treasury Secretary Geithner correctly points out: we need to get this phase right in order to minimize future crises. Understanding the crisis and its sources is essential as we evaluate the broad options before us of nationalization, privatization and a public/private system. While federal support of the mortgage system is now necessary, nationalization is not a long-run solution as it ultimately expands taxpayer exposure, while privatization without a stabilizing public role also leads to the inevitable socialization of risk, as this crisis has demonstrated.

This crisis resulted from the explosion of risky mortgages, made in the USA, the result of a lethal race to the bottom for short term profits, enabled by regulatory failure. This explosion can be traced to the issuance of private-label securities (PLS). These privately issued securities were neither standardized nor transparent; they were not traded, and, therefore, they were not subject or accountable to private sector forces of market discipline. The common sense defying loans they funded including, interest only, negative amortization, zero equity, and teaser-rate ARMs, were not designed to be affordable when full rates came into effect; and these loans drove the market to an episode of irrational exuberance of historic proportions, causing the housing bubble and inevitable bust. As these loans were pushed into the market, overall household debt to GDP rose, due to mortgage debt, with the increase coming from these risky loans.

As nonstandard mortgages proliferated, the market share of traditional mortgages declined. From 2000 to their peak in 2006, nontraditional mortgages grew in origination market share from 10% to almost 50% at their height (Wachter 2009b). In particular, the housing enterprises' share of the market dropped, as did the market share of the long-term fully amortized fixed rate mortgage that they fund, protecting borrowers from the interest rate risk which can undermine sustainable homeownership. The result of the tsunami of debt was not an immediate disaster; rather, the initial impact was an artificial house price bubble. As financial institutions loaded up balance sheets on the upswing (Pavlov and Wachter, 2009a and 2009b), they were brought to their knees on the downswing, triggering the liquidity crunch and subsequent foreclosures and the now far-reaching and ongoing economic crisis.

Incentives of mortgage issuers were negatively aligned with the production of safe, sound loans or even loans with a likelihood of payback. Riskier mortgages were more profitable in the short term, even though in the long term they brought down the system. Their greater margin was due to highly inflated fees, which uninformed borrowers paid without realizing their divergence from the norm. Fees drove the demand for securitization at every stage of production: Banks received fees to originate and distribute, the secondary market received fees to bundle mortgages, and rating agencies received fees to rate pools. At each stage, entities were able to book fees without exposure to long run-risks. Ultimately investors purchased MBS. But investors could hedge their risk also. With the purchase of newly available credit default swaps (CDS), their positions could be insured against possible loss. There was counterparty risk to be considered, but if this was evaluated, investors might have concluded that these instruments had to be backed up or the entire system would fail. The providers of the credit default swaps perhaps would have been viewed as—and certainly in the event were—"too big to fail."

The fundamental problem, then, was the lack of accountability in the system to the long-run risks being generated. Due to the illiquidity of their markets, mortgage backed securities and related derivatives traded infrequently, and short-selling these assets was not feasible—this unbalanced market dynamic led to further overpricing for MBS. Without short-selling pressure or frequent trading, prices were driven to high levels that could not be sustained. The result was that artificially inflated asset prices increased further as credit underwriting eroded, which meant that financial institutions' balance sheets were also artificially inflated (Pavlov and Wachter, 2009a and 2009b). In summary, as these balance sheets grew, the assets reflected ever-eroding standards for mortgage issuance. In the short term, cash flowed in through fees, but each fee that was accounted for represented one more mortgage that did not account for the lack of qualifications of the borrower.

For twenty-five years, securitization worked well and supported sustainable homeownership in the US. The GSEs *were* strictly regulated. Contrary to popular misconception, they were not allowed to securitize subprime or Alt-A mortgages. After they started losing market share to PLS, however, shareholder and other pressures led them to purchase PLS backed by non-standard mortgages for their portfolio. To be clear, they did not create the risky mortgage-backed securities that caused the crisis, but they did become a burden to the taxpayer because they were allowed to purchase them *after* private institutions had manufactured them. My fellow panel member Peter Wallison has documented how several GSE observers suggested Congress put limits on the portfolios, but to no avail.

More generally, financial regulators did not do their part in tracking or preventing systemic risk. With the profusion of mortgage instruments it was exceedingly difficult to determine in real time the amount and type of debt that was being issued. The extent of the asset bubble being

generated by this debt explosion was also difficult but not impossible to detect. In a forthcoming paper (Pavlov and Wachter 2009b), we trace the identifiable impact of the debt on asset prices across America, especially in the bubble states, where such loans aggressively expanded.

The most striking aspect of this story is that it never should have happened. While trading partner countries experienced house price increases as interest rates fell from the mid-1990s on, housing price inflationaccelerated in the US but not elsewhere, even with the increase in interest rates, in 2003, as nonstandard mortgages and PLS securities issuance took market share in the US. The increases in 2003 and 2004 occurred with the dramatic rise in the issuance of private label securities and the aggressive lending they supported. Colleagues and I have separately detailed the regulatory competition and regulatory failure that enabled the profusion of unsafe loans by institutions that were supposed to be regulated for safety and soundness by the federal government. While the opportunity for extraordinary compensation, in the short run, drove these markets, regulators were complicit. They failed to hold the suppliers to the long-term consequences of their actions. Federal Reserve Governor Ned Gramlich, and others, warned us as this was occurring.

To ensure the safety and long term sustainability of a re-envisioned mortgage finance system, we should pursue policies that embody three principles. First, policies and procedures are needed to identify and prevent out-of-control asset bubbles and systemic risk, under the supervision of a risk regulator. Proactive measures to warn and protect against asset bubbles must be in place in order to assure sustainable homeownership. Loan-to-value ratios, in particular, must be maintained over time. This will require specific analytics for the identification and monitoring of risks and controls to prevent the pro-cyclical production of risk.

Second, borrowers must have effective, informed choice: safe mortgages should be the presumed mortgage vehicle for borrowing. The standard mortgage must be a safe mortgage and mortgage regulation should favor safe products. To this end, it is important to create a dedicated agency, such as the proposed Consumer Financial Protection Agency. Consumer choice is inconsistent with nonstandard options that cannot be compared or priced.

Third, we need a structure that promotes and provides safe and standard mortgages through liquidity and standardization. Effective borrower choice is impacted by the structure of the system. Standard mortgages must be cost efficient. Liquidity in funding sources can assure this.

I would also like to draw your attention to a feature of today's mortgage market that we all take very much for granted, namely that a borrower can lock-in a rate in advance of closing, which means that the borrower can come into the closing knowing what the mortgage rate will be. This is possible only because of the forward or "To Be Announced" (TBA) market. In the TBA

market, the originator enters into a forward contract with the GSE issuer, in which the originator promises to deliver in the future a package of loans meeting the GSE's requirements in exchange for GSE MBS to be identified in the future. This is possible because GSE MBS of the same type, coupon, and maturity are interchangeable, unlike private-label MBS, each of which is unique in terms of credit risk and interest rate risk. The interchangeability of GSE MBS is a function of a large degree of standardization. This standardization produces sufficient liquidity to support a TBA market, which benefits consumers with guaranteed rate quotes and prevents bait-and-switch mortgage offers. Because the originator is able to resell the loan to the GSE for a guaranteed rate before closing, the originator is not exposed to interest rate fluctuations between the time it quotes a rate and closing. Without the TBA market, originators would have to bear the risk that the market value of the loan would change before closing due to fluctuations in market rates. Because of the liquidity in GSE MBS, a TBA market is possible that allows originators to offer borrowers locked-in rates in advance of closing. This is of course key to the ability of a borrower to choose a mortgage that in fact the borrower will receive at closing.

More generally, securitization should be the way to bring liquidity and cost efficiency to bear on the provision of safe and standard 30 year fixed rate mortgage. This can assure effective choice and support for a mortgage system that becomes the bulwark of sustainable homeownership in the US.

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