Testimony of Susan E. Woodward, Senate Banking Committee, October 20, 2010.

The focus of this hearing is the potential risk and unfairness of 30-year fixed-rate loans. While these loans are appealing to borrowers for their simplicity and certainty, they have the potential for problems elsewhere in the economy, ultimately falling on taxpayers. Let's go directly to the risk issues first.

The critics of the 30-year fixed-rate loan argue that this is unfair for households to get the benefits of reduced risk of fixed-rate loans while the taxpayers bear the risk. This criticism forgets that **homeowners are taxpayers too**. If we consider the situation over the lifetime of homeowner/taxpayers, there is nothing unfair about it. Indeed, it is a very desirable piece of social risk-sharing.

First, we need a few facts.

1. While the home ownership rate is between 65 and 70 percent right now, a much higher fraction of households, close to 85 percent, become homeowners at some point in their lifetime.

2. Individual incomes tend to rise over time, and peak at about age 55.

3. Homeowning households on average have higher incomes than non-homeowning households, and as a result pay more taxes.

This means that the overlap between homeowners and taxpayers is even higher than the 85 percent lifetime ownership rate. The people who benefit from our mortgage finance systems are thus the same people who pay taxes when problems arise. People benefit from the availability of a fixed-rate mortgage when they are young and have greater need for the security it provides, and the same people potentially bear a cost when they are older and have more income. The same folks who benefit from the availability of a 30-year fixed-rate loan are the ones who potentially could bear some costs from it. This is a fair trade-off and one that most taxpayer/homeowners and potential homeowners ought to find an appealing part of national housing policy.

So that's my first point: Yes, the 30-year fixed-rate loan potentially has some cost to taxpayers, but since taxpayers are virtually all homeowners too, there is nothing unfair about this situation.

As an aside, somewhat more equity in lending institutions could also provide an additional buffer between mortgage finance and taxpayers.

Adjustable-rate loans have different problems, problems that are both individual households and to the wider economy. These problems appear to be more difficult to address than the potential problems of the FRM.

The problem with ARMs is that the standard design is flawed. ARMs fail to link payment changes to household income changes. The designers of ARMs saw this problem and put in caps on the rate adjustment, typically 2 points for a given year and 5 for the life of the loan. This moves the ARM is the direction of being fixed rate. Nonetheless, the threat to household budgets is still substantial. For example, suppose the rate of inflation picked up from say, 2 percent to 4 percent, moving the homeowners' rate from 4 percent to 6 percent. The likely change in the borrower's income is the current rate of inflation – 6 percent. But the borrower's payment will rise 25 percent! Only affluent households with a lot of room to maneuver can tolerate this level of cash flow uncertainty. People are not choosing badly when they opt for a fixed-rate loan.

In addition, the ARMs can pose risks to the economy too. The recession of 1980-1982 would have been much worse, with much higher levels of mortgage defaults and an even bigger collapse in economic activity, if all borrowers had had ARM loans. How bad the macroeconomic damage canbe from US-style ARM loans in a recession with all ARMs is something we don't know, an experiment we have never performed.

For both fixed-rate and adjustable-rate loans, risk arises mainly from fluctuations in the rate of inflation, so let's talk about inflation uncertainty.

If the rate of inflation remains low, as it has since 1987 when the Federal Reserve made a new commitment to a low and stable inflation rate, changes in interest rates pose little threat to either borrowers or lenders, and thus little to taxpayers either. On the other hand, with inflation this stable, the 30-year fixed rate loan presents no risk either. With low and stable inflation, the 30-year fixed-rate loan is better because it is simpler and easier for borrowers to understand. Borrowers do not have to struggle to understand the indexes that underly ARM mortgages, and they do not have to understand the potential fluctuations in these, nor do they need to worry about exotic features of their loan that may have escaped their attention.

The FRM creates problems when the rate of inflation is higher than was expected. Lenders in the US have, they have funded long-term fixed-rate mortgages with either deposits or with other borrowing that is shorter-term than the mortgages. If the rate of inflation picks up, the cost of the short-term funding for them rises. The value of the assets fall, but the value of the liabilities does not, and the institution is potentially insolvent. Taxpayers can potentially be asked to bail out the insolvent institutions, and they were once. Though as another aside, the lenders who failed mainly failed because of the risks they took when they were "de-regulated"in the early 1980s. Those who stuck with their old portfolios recovered without bailouts.

When this happens, the homeowners have a gain, while lenders and the taxpayers potentially have a loss. These net out to zero. And as I pointed out before, the homeowners and the taxpayers are the same folks. The benefits are larger earlier in their lives, and the potential costs come at a later point when they are paying more taxes. This is a good trade, there is nothing unfair about it.

Now on to the second issue: Do we need government support for the 30-year fixed-rate mortgage?

I believe the answer is Yes.

The two most important innovations in mortgage finance in the 20th century were undertaken by the Federal government. The first was the creation of a long-term, amortizing, fixed-rate and prepayable mortgage loan. Loans of this type were made available by FHA just after FHA's creation. Mortgage loans available before this were shorter in term, usually 5 to 10 years, and were not amortizing. They were what we would today call "balloon" loans. FHA also provided, and still provides, insurance on these loans, which serves the function of making lenders more willing to lend against residential property.

The second innovation was the creation of a secondary market via Ginnie Mae. Ginnie was and is an astounding success. Ginnie Mae's role is to package already-insured FHA loans into securities that are liquid and tradable. Ginnie's creation in 1968 lowered FHA borrowing rates by 70 basis points. Given that the long-run real interest rate on mortgages is about 4%, this is a substantial savings to homeowners. There is no cost to taxpayers from this re-packaging of FHA loans. The loans were already fully insured, and this insurance is paid for by FHA borrowers. The additional risk from packaging the loans into securities is trivially small. So we get a big benefit from a government program that has no cost to taxpayers.

Why is the benefit so large? Because all parts of the financial market, including lenders themselves, prefer to hold a liquid asset than an illiquid one. It is that simple. By packing the loans into securities, illiquid whole loans are transformed into liquid securities that lenders are happy to hold at lower yields.

Ginnie was such a success that the thrifts immediately created Freddie Mac, to perform the same function for the conventional mortgage market. Fannie expanded into creating securities somewhat later, but it became the most important part of Fannie's function also.

Could the private market not create such an entity? Yes, it could, and once it did. When the thrifts created Freddie Mac, they copied the Ginnie design for themselves. I would not expect this to happen again now. When Freddie was created, even the largest thrift had only a tiny share, less than 1 percent, of the market. Both the larger and the smaller lenders had much to gain from better capital market access and more liquid assets. But now, with a few large lenders dominating mortgage lending, we should expect that the large players would not voluntarily create an institution to the benefit of their smaller competitors. These barriers to cooperation are much larger now than they were in 1968.

The private market has done some securitization of mortgages outside of our three large institutions, but it has not created the market-wide benefits that securitization through

Ginnie, Freddie and Fannie has. The reason is that these one-off securitizations are designed to make today's issue sellable, not with the view of creating an effective, liquid market for all lenders. If we are to have institutions that perform a function similar to what Ginnie Mae, Freddie Mac and Fannie Mae do, in re-packaging mortgages into liquid securities, we need some push from the government to make sure they exist.

I would hope to see one major reform to Fannie and Freddie or their successors: create a restraint so they could not again provide funding to new and unproven ideas like subprime lending. Ginnie Mae stood by and shrunk mightily as subprime expanded, while Freddie and Fannie rushed in. Ginnie's strategy was by far the better.

To make sure I cover everything of interest, I will address the committee's specific questions for this hearing.

1. What would the national housing market would look like in the absence of the FRM, taking into account the accessibility and affordability of credit for the average middle class American family as well as the importance of stable finances.

Without some federal support, specifically the support of the secondary market for FRMs, there will be a lot more adjustable-rate loans. We can expect a variety of ARMs, tied to different indexes, with different re-set periods, different caps, and different margins, much like the ARM market that was active prior to the financial crisis, but larger, with more varieties.

The 30-year fixed-rate loan is unquestionably easier for households to understand than any adjustable-rate mortgage. This simplicity is not in dispute. Even with the 30-year fixed-rate loan, we have substantial evidence that there is still borrower confusion. The terms that borrowers get demonstrate this confusion. The borrower confusion levels can only be higher on ARMs.

Survey work of mortgage borrowers indicates that essentially none of them understand the indexes to which adjustable-rate loans are tied. Finance is difficult and arcane, and peole stay in school a long time to learn it. The London Interbank Borrowing Rate (Libor)? The one-year Treasury rate? A twelve-month moving average of the one-year Treasury rate? We cannot expect any ordinary household to understand where any of these interest rates come from or to have any idea of what is the likely variation in such interest rates over the next 30 years. Only the most sophisticated households would understand them. Even phd economists have a difficult time predicting the level and volatility of interest rates. The average household will not understand what risk it is undertaking with an ARM. It will be more work for regulators to oversee an all-ARM market to try to curb abuse by lenders.

And of course we will not be free of potential macroeconomic problems coming from the mortgage market. If the inflation rate rises, and ARMs reset higher, there will be households unable to make their payments and who will default. The full force of this remains to be seen and will depend on the nature of the ARM loans that are outstanding.

2. The Committee would appreciate your thoughts on the benefits of long term fixed-rate financing for homeowners in positive and negative economic times.

When times are good and inflation is low, there is still a benefit to the FRM because it is simpler for borrowers to understand. Mortgage finance is difficult enough on even fixed-rate loans, and it is more difficult on ARM loans. With an all-ARM market, lenders and finance professionals have more tools and varieties to take advantage of borrowers who are not financially sophisticated.

In tougher times, the benefits of the FRM are less subtle. If the rate of inflation rises, the standard ARM loan puts borrowers in a difficult situation because their payments rise much faster than their incomes do. The simple result is more mortgage defaults.

3. Please also identify pieces of our current system that are necessary if the 30-year fixed-rate prepayable mortgage is going to continue to be widely available.

To begin, we should keep FHA mortgage insurance and the Ginnie Mae program for securitizing FHA (and VA) mortgages. They provide a source of stability and a continuous demonstration of what is possible in effective and constructive mortgage finance. In addition, we need government backing for a at least one entity to provide securitization to the conventional market, and entity like Freddie Mac between 1970 and 1989. The portfolio role of Fannie Mae and the post-1989 Freddie Mac are not clearly essential. We have solid evidence that effective securitization lowers rates for borrowers about 70 basis points. The benefit of the portfolios in addition is not established.

The secondary market entity could charge for a federal backstop, and could include private mortgage insurance, much as it has for 40 years. The important feature is not for the federal government to assume all of the risk, but to provide an institution that effectively provides liquidity in the secondary market.

4. Finally we would like you to discuss any concerns that you may have regarding interest rate risk for both borrowers and lending isntitutions, how that risk can best be mitigaged and by whom.

Lending institutions are well-informed specialists in assessing interest rate risk. Thus, the real key to avoiding insolvent lenders is high levels of capital. There seems to be general agreement now that bank capital standards ought to be higher than they were before the financial crisis, to make insolvency less likely from mortgage defaults and interest rate fluctuations as well.

As for risks posed to the taxpayers, the first line of defense is well-underwritten home loans that borrowers can afford. The second line of defense is the equity in lending institutions. The third line is for the government to bear some risk, as it does through deposit insurance. Taxpayers are nearly all home owners too, so the folks who potentially pay for any risks of FRMs also get the benefit of them. This trade of benefit for risk is fair and constructive for society.

This issues I discuss here I have also discussed at greater length in a paper that I wrote for the Joint Center for Housing Studies at Harvard last year. I attach that paper as well.