

Testimony of

Phillip L. Swagel

Before the Committee on Financial Services  
U.S. House of Representatives

“The Future of Housing Finance: A Review of Proposals to Address Market Structure and Transition”

Wednesday, September 29, 2010

Chairman Frank, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to testify on the future of housing finance. I am a visiting professor at the McDonough School of Business at Georgetown University and a non-resident scholar at the American Enterprise Institute. I was previously Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009.

Donald Marron Jr. and I have put forward a specific plan for reform of the government sponsored enterprises (GSEs) that ensures the availability of mortgage financing while focusing the government on its relative strengths of providing a backstop against financial catastrophes and directing appropriate subsidies for affordable housing (the plan is available on the Economics21.org website at <http://economics21.org/commentary/whither-fannie-and-freddie-proposal-reforming-housing-gses>). I will use a discussion of our proposal to address the questions raised by the committee for this hearing, including comments on alternative reform approaches and transition issues.

#### **A plan for GSE reform: Summary**

Our plan would have the federal government sell a secondary guarantee to firms that securitize mortgage-backed securities (MBS) made up of high-quality conforming loans. Fannie Mae and Freddie Mac would be privatized and focus on securitization, and would compete with other private firms such as banks that could buy the federal MBS backstop on the same terms. The government would not guarantee any particular firm—shareholders would be wiped out before the government insurance pays off in the event of a failure. Allowing new firms to purchase the government guarantee and compete with Fannie and Freddie on conforming MBS is crucial. The history of government insurance programs is that the coverage is inevitably underpriced and this gives rise to a subsidy. Competition for Fannie and Freddie will help drive the subsidy to families looking to buy a home or refinance their mortgage rather than having the subsidy accrue to shareholders and management. Moreover, with additional firms providing MBS securitization, a GSE could fail without it being a catastrophic event—the activities of other firms would ensure the continued flow of funding to housing.

The existing GSE portfolios would be wound down under the plan to remove the need for massive GSE borrowing that put the financial system at risk and necessitated the government takeover in September 2008. To preserve important features of the current system, the Securities and Exchange Commission (SEC) would provide enough regulatory flexibility to allow for the use of the TBA (“to be announced”) structure now used in the securitization of conforming MBS. Part of the insurance premiums charged by the federal government would go to funding affordable housing activities, but these would be carried out by the government and subject to normal appropriations procedures. The balance of premiums

would go into the Treasury general fund and offset over time the expected costs of the government guarantee. Fannie and Freddie and other firms engaged in securitization would not be subject to special housing goals as part of their securitization activities, though banks would remain subject to provisions such as the Community Reinvestment Act.

The choices embedded in this plan are discussed in more detail below, including the pros and cons of this approach and of alternatives. This proposal eliminates the worst aspects of the previous system—uncompensated taxpayer risk, systemic threats to the financial system, lack of transparency, and undeserved duopoly profits. It maintains an effective mortgage market for Americans looking to buy or refinance a home while putting the government role in plain sight and providing a funding source to support affordable housing activities.

### **The role of government**

Decisions on the role of the government in housing are central to reform of the GSEs and of housing finance more broadly. I start from the observation that government involvement is inevitable in housing finance, and thus a pragmatic approach is to ensure that government support is focused, transparent, and effective, while avoiding systemic risks and the situation of public risks and private gains that characterized the former GSE model. Government involvement is inevitable because a government backstop is necessary to ensure the availability of 15- and 30-year fixed rate mortgage products with no prepayment penalty. Other nations have vibrant housing markets and high rates of homeownership with less or no government involvement but also with different mortgage products. I take it as a given that Americans on the whole will want these types of mortgages rather than ones with floating rates and a limited ability to prepay and this is enough to necessitate a government backstop of some sort.

A second reason for an explicit government backstop on housing finance is perhaps more profound: in the next financial crisis--whenever that occurs--it is inevitable that the government will step in to ensure that mortgage financing is available on reasonable terms. This means that a government backstop is latent—markets will act as if it is there but without providing compensation to taxpayers. This is not a problem that can be solved but a fact of life. It would be far better to make the terms of this support explicit and priced rather than leaving it implicit.

Having acknowledged that government involvement is inevitable, it should be as limited as possible. Government involvement in housing finance will take place in at least three dimensions: (1) providing credit guarantees against the financial consequences of mortgage defaults; (2) as a buyer of last resort for mortgage-backed securities; and (3) directing resources to provide subsidies for affordable housing. These are all appropriate roles for the government—and are activities not well-accomplished by private sector entities such as the retained portfolios or housing goals in the former GSE model. It would be best to cleanly separate the function of securitization that can be performed by the private sector from these other activities.

### **Returning Securitization of Conforming MBS to the Private Sector**

A key outcome for housing finance reform is to make Fannie Mae and Freddie Mac again into private firms focused on securitization. The two firms should be truly private without any of their former special privileges such as lines of credit at the Treasury, government board members, special treatment of GSE securities on government ethics forms, and broad exemption from SEC registration. As discussed below, a limited special SEC treatment would cover securitization of conforming mortgages to allow for

the useful TBA structure, but this would extend to all firms performing securitization and not just to Fannie and Freddie.

The newly private Fannie and Freddie would pay insurance premiums to the federal government for a secondary guarantee on mortgage backed securities composed of conforming loans that meet high standards set by their regulator (and as discussed below, other firms would be allowed to purchase this federal backstop and compete with the existing two GSEs). These premiums would be priced at an actuarially fair level—a rate meant to compensate the government for defaults on average over a mix of normal and stressed environments. It is an impossible task to calculate precisely the right premiums, but the best attempt of the regulator will be preferable to the un-priced implicit insurance in the old system. The federal guarantee would be secondary in that substantial private capital would stand in front of the government, with the precise amount to be determined by the appropriate regulator (the FHFA or perhaps the new financial stability oversight council). The public backstop would kick in only after the shareholders of a firm performing securitization and guarantee of conforming MBS are entirely wiped out—the federal government would guarantee the MBS and thus ensure that mortgage liquidity is available even in times of financial stress, but would not guarantee any particular firm. It would not be advisable to set up a new insurance fund in a government system already replete with easily-misunderstood trust fund accounts. Instead, the premiums should go into general revenue with the Treasury providing funds to make good on the full-faith-and-credit guarantees as needed.

The privatized GSEs should not be allowed to rebuild retained portfolios. While in the end the guaranty business rather than retained portfolios accounted for the bulk of GSE losses, the massive borrowing to fund the portfolios gave rise to an intolerable systemic risk that made the GSE bailout necessary in the first place—allowing the GSEs to fail in the fall of 2008 would have posed serious capital challenges to the large number of banks holding GSE debt (a manageable number faced difficulties from losses on GSE preferred shares). A future housing finance system should not allow any firm to parley a federal guarantee into a hedge fund-like investment structure. The activities of the newly privatized GSEs should thus be restricted in this regard for a considerable period—at least until there is enough competition in securitization of conforming loans to make it possible for one of the existing GSEs to fail without requiring a government bailout.

### **Allowing other firms to compete with the GSEs**

Along with selling Fannie and Freddie back into private hands, GSE reform should allow other firms to compete on a level playing field in the securitization and guaranty business. Even with the best efforts of the regulator, it is likely that the government will charge too low a premium for its insurance and this gives rise to an implicit federal subsidy to the private sector. Allowing for competition and entry in the functions of securitization and guaranty is thus important to ensure that this subsidy passes through to American families looking to buy or refinance a home rather than being captured by GSE shareholders and management.

To foster these beneficial effects of competition, other firms would be allowed to purchase the federal secondary backstop on conforming MBS on the same terms as the existing GSEs. It would be natural to expect large banks to enter this market, notably national institutions with the volume of mortgage origination to support an in-house securitization apparatus. The newly-privatized Fannie and Freddie would not have retail operations that originate mortgages, but they would compete as network companies based on the strength of their automated underwriting systems and electronic connections to banks. Over time, Fannie and/or Freddie might well acquire a bank or be acquired by one. Subject to

regulatory scrutiny, this sort of evolution of the housing finance system would be welcome so long as there remains sufficient competition in the securitization and origination of mortgages.

In allowing for entry, it will be important for both the FHFA and banking supervisory agencies such as the Federal Reserve and the Office of the Comptroller of the Currency to ensure that banks do not use financial engineering to extend the federal backstop on conforming loans to other parts of their balance sheet. Support must go in one direction only—shareholders of a bank that enters into securitization will take losses ahead of the federal government on conforming MBS, but taxpayers would not support an institution that becomes financially unstable for any reason (whether from losses on guarantees or on assets other than conforming mortgages). The key is that with entry, a GSE or a new securitizing firm such as a large bank could fail without it being a catastrophic event for housing finance or the economy more broadly—other firms would continue to securitize MBS and ensure the flow of funding to housing.

The alternative approach of a private sector cooperative suffers from the problem that having a single such cooperative or even two of them would recreate a system of firms that are too big to fail, just as Fannie and Freddie were (and are) too important to be allowed to fail. For this reason, if GSE reform does not include entry and competition, it is probably better to choose a heavily regulated utility approach in which the two or even one GSE-like firms are explicitly designated as too big to fail and regulated as such with strict limits on activities and rates of return. While one might then naturally contemplate just making this activity entirely a governmental one, the experience of public sector insurance providers suggests that there will be substantial pressure for insurance premiums to be set intentionally too low and thereby encourage unintended risk-taking. Having some private capital at risk, even if heavily regulated, at least provides incentives for prudent behavior.

Allowing for entry and competition could have important benefits for future innovation in housing finance. One possibility, for example, is that securitizers could put together MBS without the federal backstop. Mortgages in these securities would not pay for the federal insurance premium and this would involve a lower interest rate, but offset by the additional risk involved in forgoing the credit guarantee, which would translate into higher interest rates demanded by market participants. Whether the net impact is for higher or lower interest rates than ones with the federal insurance would depend on the pricing of the government backstop. Such non-guaranteed MBS would be akin to subordinated debt in the previous GSE model and would provide a market-based indication of the perceived value of the federal backstop.

### **Regulatory actions as part of housing finance reform**

The “to be announced” (TBA) structure now used in the securitization of conforming mortgages provides for important benefits in the system of housing finance, including added liquidity and the ability for homeowners to lock in mortgage rates for a reasonable period of time. This system should be preserved in GSE reform, including through SEC actions that provide an exception for security registration procedures with strict oversight to avoid abuse. Allowing competition would spread the universe of conforming mortgages over additional TBA pools and this has the potential to reduce liquidity. This is a downside of a model with competition and entry, but it remains an empirical question the extent to which liquidity would be reduced and mortgage rates rise as a result. It is possible, for example, that a system that keeps the structure of the TBA pools intact through standard setting and close cooperation between securitizers, regulators, and industry participants would ensure a continuation of the benefits of the existing system. And again, allowing for competition and entry has important benefits for

homeowners in terms of lower interest rates and for society in terms of moving away from firms that are too big to fail.

A government backstop on conforming-mortgage-backed securities will put substantial stress on the definition of a conforming loan, because mortgage originators will naturally look to fit as wide a range of loans as possible into the federal insurance coverage. This is unavoidable in a system with government involvement, but at least regulators will be well aware of it and can shine a bright light on the quality of conforming loans. The fact that taxpayer funds are explicitly at risk likewise means that securitizing firms must have substantial high-quality capital in front of the public, both at the level of the individual loan with down payments and in each firm in terms of common equity. In addition to ensuring that conforming loans remain of high quality, regulators will need to ensure that firms engaged in housing finance have the necessary private capital. The crisis revealed that private mortgage insurance (PMI) firms did not have sufficient capital to withstand a nationwide housing reversal. If PMI is allowed to operate under the new system of housing finance, there should be no “discount” on the amount or quality of private capital ahead of the government—PMI could usefully represent a part of the mix of private capital protecting taxpayers but not any diminution of it. A careful assessment, however, might call into question the entire model of private mortgage insurance playing a role in the high-quality conforming loan space.

In the past, proponents of GSE reform were sometimes attacked as being “anti-housing” on the grounds that reform would lead to higher interest rates. This is correct for any GSE reform in the sense that requiring securitizers to hold more capital will tend to raise mortgage interest rates—after all, capital is expensive. This criticism could further apply to a world in which the federal backstop is priced rather than implicit, as the federal insurance premiums would tend to translate into higher interest rates as well. And yet, GSE reform should still go forward, since higher interest rates would represent the impact of additional protection for taxpayers and the financial system. Moreover, these effects would be offset by the beneficial effects of competition that would ensure that any underpricing of the government insurance is passed through to lower mortgage interest rates rather than captured by GSE shareholders and management. Nonetheless, it should be recognized that GSE reform that protects taxpayers against a repeat of the costly conservatorship implemented in 2008 likely will involve higher overall mortgage interest rates. If this is undesirable, Congress should provide an explicit appropriation to subsidize lower rates for desired borrowers or for well-targeted affordable housing purposes.

### **Support for the economy and for affordable housing**

The federal backstop will ensure that mortgages are available even in times of financial crisis, but it is still possible that a shortfall of private demand for housing-related assets could lead to high interest rates that are undesirable from a macroeconomic standpoint. The government could then step in as a buyer of last resort for mortgage backed securities, boosting demand for MBS and lowering interest rates and stimulating the economy. This is best seen as an action for macroeconomic demand management, and thus most appropriate for the Federal Reserve as part of future broad based efforts aimed at monetary policy stimulus. The proposal outlined above would leave in place this ability for the Fed to act. The GSEs themselves and other firms involved in securitization should not play a role in macro-demand management and should not be seen as a buyer of last (or first) resort for mortgage backed securities. It is the case that previous GSE purchases for the retained portfolio provided some additional demand for affordable housing. But it would be better to accomplish the important social purpose of fostering affordable housing in more transparent and effective ways rather than through private firms with potentially conflicting missions.

The federal insurance premium provides an appropriate funding source for affordable housing initiatives. The next step is to specify the types and beneficiaries of these activities—to go beyond saying that “more should be done” to detail precisely what to do and who should receive federal assistance. Under the current system, families purchasing homes with prices above \$700,000 receive a portion of the federal subsidy for housing finance as part of an expansive definition of a conforming loan. It could be in the future that Congress decides to target affordable housing resources instead on families with lower incomes and assets. Moreover, rental assistance could be an important component of a suite of policies to foster improved access to affordable housing. These are important decisions. For reform of housing finance, it is essential that these activities be part of the public sector and not carried out within successor firms to the GSEs. Congress should vote on the use of all public resources, including for affordable housing activities.

### **The disposition of existing GSE portfolios**

An important transition issue is the disposition of existing GSE assets and liabilities. Taxpayers are already on the hook for losses embedded in the GSEs’ existing portfolios of mortgages, MBS, and guarantees, and these should be brought onto the public balance sheet and managed over time. In this so-called “good bank/bad bank” approach, Fannie and Freddie would then be privatized through initial public offerings as firms with clean balance sheets and profitable businesses performing securitization and guaranty for high-quality conforming mortgages.

As an accounting matter, it might be possible to continue the present arrangement in which the \$5+ trillion of assets and liabilities of the two firms are not on the public balance sheet and the Treasury covers only incremental losses. This suffers from a lack of transparency and should not be done. There might have been worries in the fall of 2008 about the financial consequences of expanding the public balance sheet by this huge amount. But it is now well understood that the federal government effectively stands behind GSE liabilities and that these are essentially offset by a nearly equivalent amount of assets on which the federal government has a claim as the effective owner of the GSEs. The federal preferred shares layered on top of the 79.9 percent public share of Fannie and Freddie common stock ensures that the pre-existing GSE common and preferred stock will have little if any value in a privatization—indeed, taxpayers will in the end lose substantial sums on the GSE intervention, perhaps more than the \$150 billion already put into the two firms once all the embedded losses are realized and the firms are sold off. Even so, privatization will remove the possibility of further losses from new GSE activities undertaken for policy purposes.

### **Conclusion**

It is important to move thoughtfully in reform of housing finance, but I submit that it is also useful to move expeditiously. The housing market is still weak, but this is not on account of a lack of financing—indeed, the existing federal conservatorship has ensured ample liquidity for well-qualified buyers. The larger problem in housing is instead the lingering effects of the collapse of the housing bubble, including the mass of foreclosures still to come that will weigh on housing prices into the future. With overall financial market liquidity supported by accommodative monetary policy, financial conditions could be seen as supportive for a return of private capital to housing finance. After all, market participants face otherwise low yields on relatively safe assets – and post-bubble, high-quality conforming loans with a government backstop should be seen as such.

It is likewise useful to speedily return the GSEs to private hands to avoid the temptation for the executive branch to use Fannie and Freddie for unchecked spending without a vote of the Congress as would be possible if the firms were directed to intentionally take losses for a policy purpose. One could imagine, for example, the GSEs being directed to facilitate the refinance of homeowners into loans with lower interest rates—effectively a transfer from taxpayers and other owners of the affected mortgages to the fortunate borrowers.

Of all the decisions, the most critical are those on the form of the government guarantee on housing and the market structure of the firms involved in securitization. There are substantial benefits to be had from a framework in which private firms compete and innovate, backstopped by a limited government guarantee to ensure liquidity under stressed market conditions. Allowing for entry and competition into securitization and guaranty will ensure that the benefits of government support go to homeowners, while preserving the essential merits of the existing mortgage finance system.

Mr. Chairman and Ranking Member, thank you again for the opportunity to testify before the committee today. I would be pleased to answer any questions.