



# Economic Observatory

August 3<sup>rd</sup>, 2009

## Serious discussion of mortgage finance reform in the US

- Top housing finance regulator suggests Fannie Mae and Freddie Mac need countercyclical capital requirements
- Options under review include privatization, public utility model, cooperative ownership, or reduction in retained portfolios
- While focus is currently on organizational structure, reforms should instead center on structure of products and diversity of instruments

## Mortgage finance, government entities and reforms

In a speech on 30 July 2009 to the National Press Club, Federal Housing Finance Agency Director James Lockhart outlined possible future reforms for Fannie Mae, Freddie Mac and other government-sponsored entities (GSEs) that form the housing finance infrastructure in the US. These organizations represent a large influence on the mortgage market as the obligations of all the housing GSEs (Fannie Mae, Freddie Mac and the 12 Federal Home Loan Banks) are \$6.6bn and they own or guarantee 56% of single family mortgages in the US. Credit downgrades, troubled private label securities and illiquidity in the secondary market continue to cause trouble for the GSEs. Lockhart mentioned that it was unlikely that the US government would ever recoup its \$85bn bailout of the GSEs.

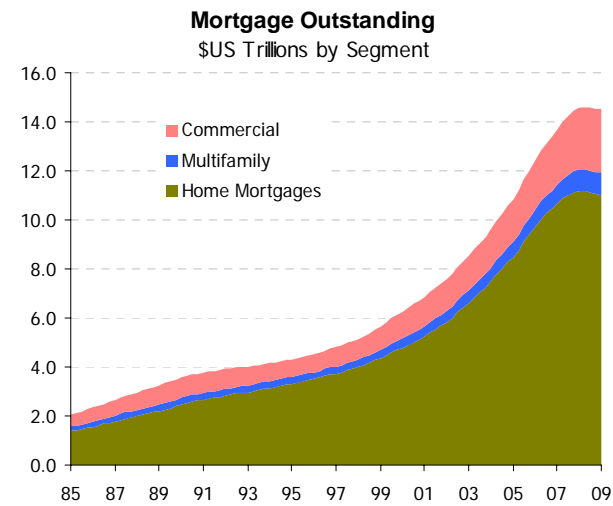
## Direction of the US secondary market for mortgage finance

Lockhart expressed that reforms of Fannie Mae and Freddie Mac essentially boil down to how the government wishes the secondary mortgage market to operate. One major part of these reforms will be changing the exposure and degree of risk-taking of GSEs.

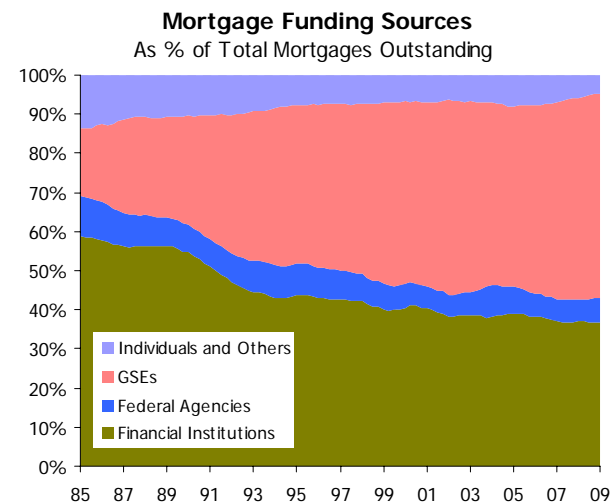
"Any federal risk-bearing should be provided explicitly and at actuarial cost. The old hybrid model of private, for-profit ownership underwritten by an implicit government guarantee allowed the Enterprises to become so leveraged that they posed a large systematic risk to the US economy," Lockhart said.

A second major element of reforms should involve countercyclical policies, according to Lockhart. Efforts in this vein should be to curb asset price bubbles, dampen credit cycles, improve the odds of financial institution's survival of a crisis, and reduce the occurrence of fire sales and credit crunches. One possible way of implementing this principle is to reduce capital requirements as real house prices fall

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Source: Flow of Funds. Federal Reserve



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below trend and increase them as real house prices rise above trend, according to Lockhart. However, trends are subjective in practice.

Lockhart also mentioned possible changes to the organizational structure of US GSEs, suggesting three possible options: (1) nationalization, (2) continued reforms of the current model, or (3) privatization. Lockhart is opposed to nationalization, but mentioned that the government may have a beneficial role in providing catastrophic reinsurance to the secondary mortgage market. The second option is currently under review, but it may or may not resolve the “tension between private profit and public purpose,” according to Lockhart. The reforms may consider the GSEs as a public utility and may involve a reduction in retained portfolios or cooperative ownership (akin to the Federal Home Loan Banks). The last option involves the creation of private mortgage exchanges and greater competition in the mortgage market through privatization.

**Product structure, not organization structure**

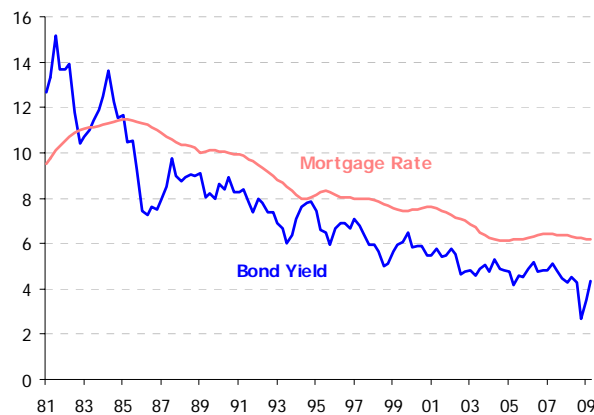
Over the coming year, regulators and financial institutions will increasingly discuss reforms of the US GSEs. However, the current state of the dialogue on this issue continues to focus on the structure of the organizations rather than on the structure of products. While the securitization model predominates in the US, in Europe a wider variety of products offers consumers different options and financial institutions greater diversity in mortgage finance investments. For example, many European countries have used covered bonds to finance mortgages for decades. These financial instruments are often insured more than once, giving their default probability a much different distribution than a securitized product. Covered bonds remain on the issuer’s balance sheet, thereby incentivizing the issuer to produce a quality financial product. Additionally, in Europe the structure of securitized products relies more on retained credit risk on the part of the issuer, linking risk more closely with the issuer’s creation of the end financial product.

Discussion regarding the structure of organizations only arises from the uniqueness of the American public-private structure for pooling and securitizing mortgages. The GSEs maintain huge economy of scale in production – it would be unlikely to have the same cost advantage of securitized products without the GSEs in place. Any change in the level of involvement by the GSEs will result in a significant reorganization in the private sector for mortgage finance. As a result of these difficulties and wide-ranging influences, it is most likely more effective to consider what kind of mortgage products are desirable. Once the products reach a desired level of quality and functionality, the structure of the firms and organizations will emerge organically from the features of the products themselves.

**Bottom line: making homes affordable the old-fashioned way**

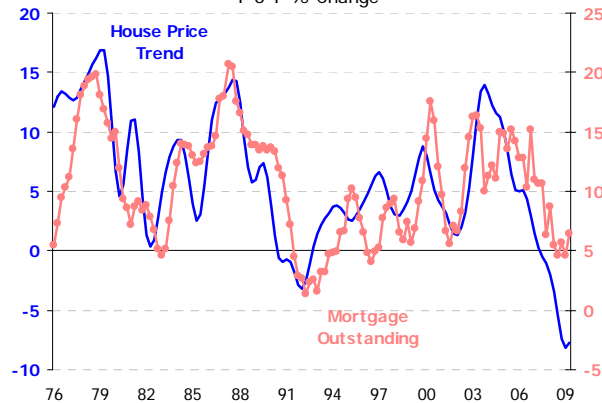
Efforts to reform mortgage finance in the US will tend to focus on reducing the risk posed by the leverage and activity of GSEs. To achieve this result, regulators are discussing organizational changes to these entities, but in reality reforms are needed to the structure and diversity of mortgage financial instruments in the US.

**Government 30 Y Bond and Mortgage Rates**  
Yield and % 30 Year FRM



Source: Treasury and Federal Reserve

**House Prices and Real Estate Outstanding**  
Y-o-Y % Change



Source: Census and Federal Reserve