The Future of the Secondary Market For Mortgages

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Four Basic Questions

1) Is securitization even necessary? Are there other ways to access the capital markets without the use of mortgage-backed securities?

2) Why is any government support needed?

3) If taxpayer dollars are to be put at risk, how do we limit that risk?

4) How do we explicitly avoid the mistakes made in the past with Fannie Mae and Freddie Mac?

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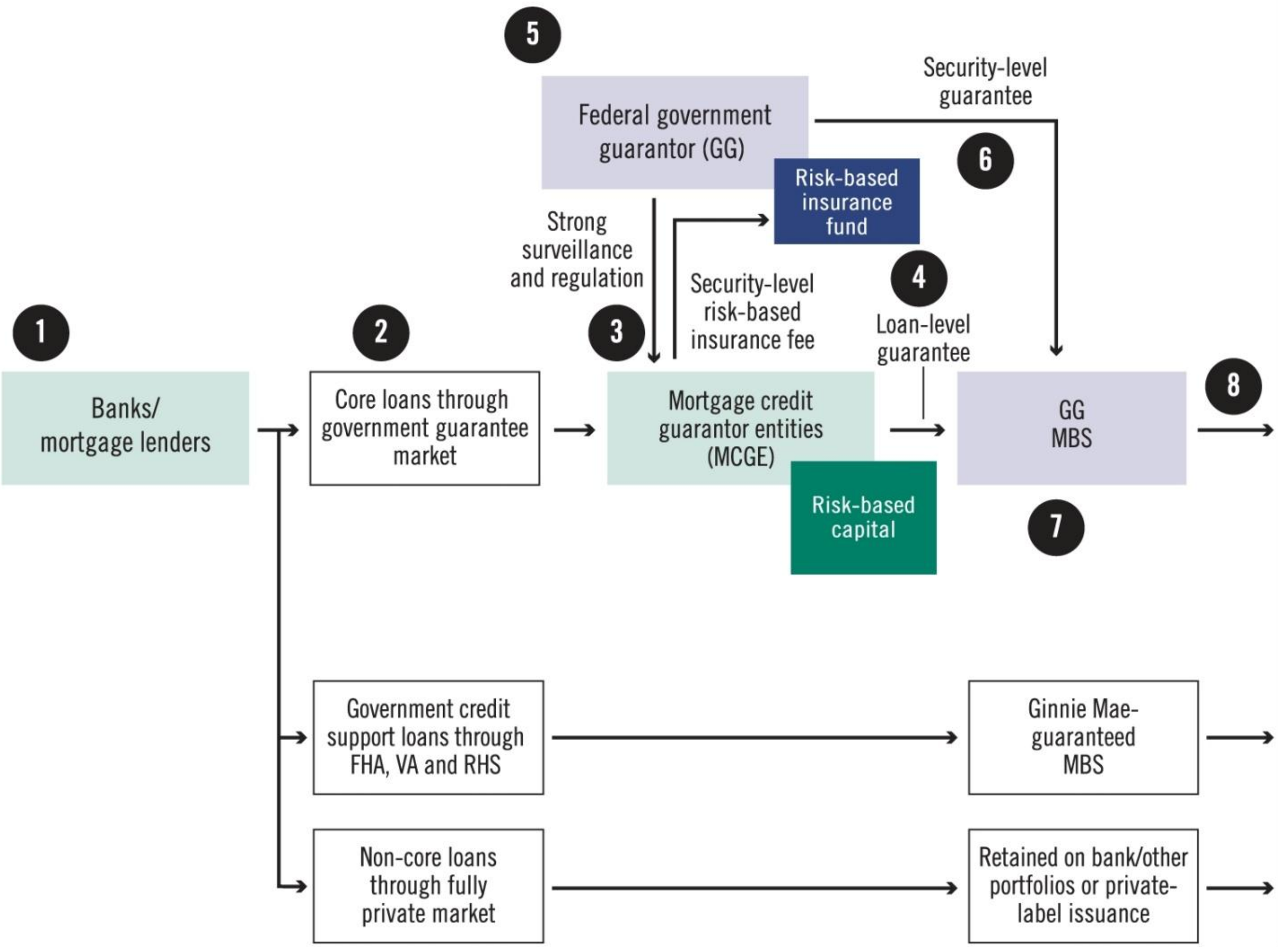
MBA Recommendation

HIGH-LEVEL VIEW

TARGET STATE: POTENTIAL ROLE OF THE FEDERAL GOVERNMENT IN THE CORE SECONDARY MORTGAGE MARKET



1. Mortgages are originated.
2. Mortgages are submitted to MCGE for credit underwriting and pooling.
3. MCGE prices and holds capital for the credit risk of the loans.
4. MCGE guarantees timely payment of principal and interest of the loans.
5. Federal agencies provide oversight, regulation and security-level guarantee in exchange for risk-based fee.
6. GG guarantees timely payment of principal and interest of the security.
7. MCGE or mortgage lender issues GG security to the market.
8. Based on the GG guarantee, security trades in equivalence to full faith and credit of the U.S. government; security buyer takes all the interest rate risk.

Is securitization even necessary?

1) How best to handle the interest risk of 30-year fixed-rate mortgages?

2) The thrift mess in the 1980s showed that depository institution portfolios are not the answer.

3) Even moving to greater use of adjustable rate loans that could be held in bank portfolios would still concentrate mortgage risk on bank balance sheets and therefore put the taxpayers at risk though the FDIC insurance fund.

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Why is any government support needed?

1. Securitization is alternative liability structure for funding mortgages.
2. Similar to the situation with bank deposits, you have multiple holders of identical claims against the same pool of assets, and those holders have imperfect information about the current state and future performance of those assets.
3. Since those who sell first suffer the smallest losses, there is an advantage to sell quickly before a panic, thus helping create a panic.
4. The problem is exacerbated by mark to market issues for some holders.

Dealing with panic liquidation by liability holders

Banks	
Loans	Deposits
	Equity

Securitization	
Loans	Securities
	Equity (Including guarantees & subordination)

Protection from panic redemption of liabilities provided by FDIC insurance fund and taxpayers.

Protection from panic redemption of liabilities provided by implicit (now limited explicit) guarantee of Fannie Mae and Freddie Mac, and taxpayers.

If taxpayer dollars are to be put at risk, how do we limit that risk?

1) Make sure that private capital is the first line of defense against losses, with no institution too big to fail.
2) Establish an insurance fund as the second line of defense.
3) Tighten the credit box of allowable mortgages.
4) Make explicit what is and is not supported. Move from an enterprise-level implicit guarantee to an explicit security-level guarantee.
5) Establish explicit fees for compensating the government for the guarantee.
6) Remove the housing goals and the distortions those goals caused in the market.

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Avoiding the mistakes of the past

- GSEs were allowed to set essentially any credit standards they wanted, including moving into subprime loans, low documentation loans and pay-option ARMs, all now guaranteed by the taxpayers.

- *MBA's proposal will limit the credit box, limiting the loans that can receive federal support to a narrowly defined set of criteria and risks, essentially just the loans that are crucial to the continued operation of the market.*

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Avoiding the mistakes of the past

- The GSEs engaged in a number of activities and other investments outside of mortgage securitization, all of which are now guaranteed by the taxpayers.

- *MBA's plan eliminates this by moving away from an enterprise-level guarantee to a security-level guarantee. Only the securities issued by the new entities would carry any sort of guarantee, not the companies themselves.*

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Avoiding the mistakes of the past

- The GSEs paid nothing for the implicit guarantee of all of their activities.

- *The MBA plan makes explicit what is guaranteed and establishes an explicit, risk-based payment for that guarantee.*

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Avoiding the mistakes of the past

- The large, highly leveraged investment portfolios of the GSEs had tremendous amounts of interest rate and liquidity risk, risk that in turn weakened the ability to make good on the credit guarantees.

- *MBA's plan prohibits the new firms from holding portfolios except for what is needed for securitization and managing defaulted loans. Since the debt of the entities is explicitly not guaranteed, it is unlikely the entities could profitably hold portfolios or hit market ROEs on required capital.*

Avoiding the mistakes of the past

- Even small reforms of the activities of the GSEs became mired in politics because their charters were established in law and controlled by Congress. The inability to charter new GSEs led to a lack of competition between the two firms.

- *MBA’s plan eliminates the Congressional charters and establishes chartering authority in the new regulator similar to the OCC and other bank regulators.*

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Avoiding the mistakes of the past

- Similar to the problems with the dual mission assigned to Fannie and Freddie, their regulator has had a dual mission of promoting housing and regulating safety and soundness.

- *MBA's plan removes HUD-type housing goals from the new entities so the new regulator can focus on safety and soundness.*

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Variables Used in Calculating the Risk-Based Capital of the GSEs

TABLE 1.—SINGLE FAMILY DEFAULT & PREPAYMENT VARIABLES

Variables for All Single Family Models	Single Family Default Variables	Single Family Prepayment Variables
Mortgage Age	X	X
Original LTV	X	X
Probability of Negative Equity	X	X
Burnout	X	X
Occupancy Status	X	X
Relative Spread	....	X
Yield Curve Slope	....	X
Relative Loan Size	....	X
Product Type (ARMs, Other Products only)	X	X
Payment Shock (ARMs only)	X	X
Initial Rate Effect (ARMs only)	X	X

No mention of credit scores or income documentation among the variables determining risk-based capital for Fannie and Freddie.

Source: 12 CFR 1750, Risk-Based Capital, Final Rule, September 13, 2001, Page 47733

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Conclusion

Opportunity to learn from mistakes and rebuild the system from scratch:

- Private capital must be the first line of defense
- Limited and well-defined federal guarantee
- Explicit risk-adjusted fees for explicit guarantees
- Do not combine credit risk and interest rate/liquidity risk by allowing entities to hold portfolios.