Testimony of
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Fundamental Housing Finance Improvements

Mr. Chairman, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a senior fellow at the R Street Institute, and these are my personal views. I have worked many years in the practice and the study of housing finance, including having previously been president and CEO of the Federal Home Loan Bank of Chicago, a resident fellow at the American Enterprise Institute, and president of the International Union for Housing Finance. While at the Chicago FHLB, I led in the creation of Mortgage Partnership Finance. The MPF mortgage portfolio demonstrated superior credit performance through the 2007-09 crisis because its structure requires the mortgage lender to keep credit "skin in the game." While at AEI, I designed the "one page form" of the key information a mortgage borrower needs to understand. I am the author of many articles, testimony and presentations on housing finance reform, including what to do about the $5 trillion problem of Fannie Mae and Freddie Mac, which lingers on and on.

The discussion draft of the "Bipartisan Housing Finance Reform Act" very helpfully develops approaches to central issues involved in the reform of the American housing finance system. This system is unique in the world. Its continuing problems reflect the double traumas of the collapse of American housing finance twice in the last four decades: once in the 1980s and again in the 2000s. It would be a major contribution to get it fundamentally improved going forward. I believe today's hearing should help relaunch that essential project.

My testimony addresses six main points in what I think are fundamental principles of reform:

-The overall goal of housing finance reform
-Optimal alignment of incentives and risk
-Avoiding procyclical inflation of house prices

-Setting the price of government guarantees
-An alternative path for Fannie and Freddie
-The potential role of the Federal Home Loan Banks

1. The overall goal of housing finance reform

A principal objective of the Bipartisan Housing Finance Reform discussion draft is significantly to move mortgage credit risk exposure from the government—including from Fannie and Freddie, which are now government mortgage banks—to private risk capital. This is without doubt a good idea and is a widely shared goal.

American residential mortgage loans, totaling $10.3 trillion, comprise the biggest credit market in the world, except for direct sovereign debt. To concentrate so much of mortgage credit risk on the banks of the Potomac, as the 1990s and 2000s did, was obviously a major blunder. Yet as we all know, this concentration continues: The mortgage guarantees of Fannie, Freddie and Ginnie Mae now total about $6.5 trillion, or 63% of the total mortgage credit.

Programs transferring credit risk from Fannie and Freddie to private investors, as part of the strategy instituted during their conservatorship, have proven possible in practice, as well as in theory. The Bipartisan Bill would design structures to institutionalize and expand this movement of credit risk, systemically putting more private capital in front of the government's mortgage risk guarantee. Under the proposed structure, however, this government guarantee would become explicit through the great expansion of Ginnie Mae.

The proposed move to increased private credit risk bearing is fundamental and positive, although in the next section I recommend what I believe is an essential addition to this strategy.

What is the overall goal for reform? In my view, we should be heading for a reform which transforms the system into one which is 80% private and only 20% government. We are obviously a very long way from that today. The Bipartisan Bill would move us in the right direction, and I will suggest ways to move us even further toward the 80% goal.

2. Optimal alignment of incentives and risk

The best place for mortgage credit risk to reside is with the lender who makes the loan in the first place, even though the loan may be funded somewhere else, including in a securitization. For that originator to retain significant credit risk "skin in the game" for the life of the loan assures the best possible alignment of incentives for credit management. It also ensures the system utilizes the knowledge of the borrower and the credit factors which are available directly to the lender as the loan is being made.

This was the founding principle of the Federal Home Loan Banks' Mortgage Finance Program, in the launch of which I had the honor to be involved two decades ago. Its alignment of credit incentives proved over time to perform well, as we had expected. This was indeed no surprise, since the advantage of the original lender having skin in the game is ancient credit wisdom. It was part of the original design of Freddie Mac mortgage securities, for example. Nonetheless, the majority of American housing finance came to be built on exactly the opposite theory, with needless to say, disastrous results.

In the wake of the crisis of 2007-2009, a lesson universally said to be learned was the need for more credit skin in the game. It would be good not to let this lesson fade away.

I am not suggesting that lender skin in the game should be a universal requirement. It does not work for all mortgage lenders, especially not for mortgage bankers with little capital relative to their volumes, or all situations. But it where it does work, such as for mortgage lending by financial institutions, I think it should be encouraged by law, policy and regulation.

Independent private credit enhancers, like those envisioned in the Bipartisan discussion draft, can coexist in a competitive mortgage market with structures based on originating lender credit skin in the game. I do think the latter a superior credit alternative.

3. Avoiding procyclical inflation of house prices

Excessively easy credit standards and cheap mortgage credit get capitalized into increased house prices. By trying to make houses more affordable in one way, government subsidies and underpriced guarantees make houses less affordable in another way, i.e. more expensive. The same is true of the Federal Reserve policy which has kept interest rates extraordinarily low for an extraordinarily long time: by making mortgage interest rates lower, it made houses more expensive. The combination of government credit and government interest rate policy have now brought house prices back to their bubble-era levels.

All housing finance reform should consider the likely effects of its policies on the behavior of house prices, especially the procyclical inflation of house prices in a boom, which means they can deflate more in the bust. We are now experiencing the second big house price inflation of the 21st century.

Although asset prices naturally vary over time, we should try to avoid structures which inflate house price bubbles. We should have countercyclical disciplines when prices are rapidly rising. I believe the best we can do to dampen price distortions is to move toward the goal of making the housing finance system 80% private. By moving in this direction, the Bipartisan discussion draft would tend to entail less house price distortion than does the current system, although as has been pointed out, FHA reform needs to be added to it.

4. Setting the price of government guarantees

Underpriced government guarantees are sources of economic distortions in general and of mortgage credit inflation, in particular. Fannie and Freddie got a free guarantee from the Treasury, the ultimate in underpricing. The guarantee fees they charged their customers reflected their own hyper-leveraged, severely undercapitalized balance sheets. The excess leverage was made possible by the free Treasury guarantee.

If there are to be any government guarantees of mortgage credit, at any level or in any form—as would would be prominent in the Bipartisan discussion draft proposals—how such guarantees are priced is an essential consideration.

The correct principle for setting the price has already been enacted by the Congress for Fannie and Freddie, although it has not been implemented by them or by the Federal Housing Finance Agency. This is that guarantee fees are required to be calculated including the cost of the capital that would be required for a regulated private financial institution to bear the same credit risk—a simple and powerful concept.

This concept is a specific provision of the Temporary Payroll Tax Cut Continuation Act of 2011, in its Title II, Section 401, "Guarantee Fees." This is a tremendously important provision, although it is almost unknown. The result of implementing it—of implementing what is already explicit law for Fannie and Freddie-- would be to bring more private capital into the market, create a more competitive market, take away the underpricing of risk, and remove the regulatory capital arbitrage that shifts the risk and ensuing bailout on the taxpayers.

This pricing principle should be applied to any and every government guarantee that is or becomes part of the American housing finance system.

5. <u>An alternative path for Fannie and Freddie</u>

The Bipartisan discussion draft would abolish the charters of Fannie and Freddie, but would replace their current functions with a complex set of new institutional structures and relationships.

Newly designed complexity, however much it has been thought about in advance, is a risk. It is impossible to know what really will happen in complex designs as market actors change their strategies, cycles cycle and booms turn to busts, and circumstances change in unanticipated ways, as they always do. Complexity begets surprises, and the discussion draft seems to anticipate a level of foresight in the Federal Housing Finance Agency and Ginnie Mae which seems to me pretty unlikely.

An alternative would be to allow Fannie and Freddie to continue their current operations, but simply treat them for capital and regulatory purposes the same as every other giant financial institution. They should have the same capital standards and prudential rules as JPMorganChase, Citibank, Bank of America, Wells Fargo, and the other biggest systemically important financial institutions. They should be legally defined as the SIFIs they are. These steps would automatically remove the regulatory capital arbitrage which drove their excessive expansion and riskiness in the past.

As part of such an institutional normalization, Congress should remove Fannie and Freddie's special government privileges and make them pay for their formerly free Treasury guarantee, turning them from "GSEs" into normal competitors, and creating a competitive, instead of duopolistic, mortgage securitization market. These changes in Fannie and Freddie's charters would not be without various complications, but are less radical than abolishing them, and less complex than inventing new structures. Such an approach would also avoid the uncertainties involved in the explosion in the size, monopoly power and risk of Ginnie Mae, which the Bipartisan discussion draft now implies.

Under such a regime, upon private recapitalization, Fannie and Freddie could sensibly be released from conservatorship to sink or swim on their own in a competitive market.

6. The potential role of the Federal Home Loan Banks

(I remain intrigued, as a student of housing finance systems, with the potential contribution of the Federal Home Loan Banks to a reformed system. The following comments in no way represent the FHLBs and are controversial within the FHLB System.)

The Bipartisan discussion draft envisions a larger role in mortgage finance for the Federal Home Loan Banks, with the purchase and securitization of conventional mortgage loans from smaller financial institutions. This is definitely a good idea, but the FHLBs could make a bigger contribution to a reformed housing finance system. With $1.1 trillion in assets, more than 7,000 member financial institutions, and existing mortgage programs which have worked for more than 20 years, they have the base to do so.

Specifically, I recommend that the FHLBs be authorized to form, own and manage a joint subsidiary dedicated to mortgage finance, including securitization and also advancing structures with lender skin in the game, on a national basis. A subsidiary with national scale could be a strong competitive force in expanding mortgage finance on a robust credit basis. It would be especially advantageous for small, local mortgage lenders throughout the country, who know their own markets well, and for their mortgage borrowing customers.

I have previously participated in drafting a bill to create such an FHLB joint subsidiary, and remain convinced of its potential. The draft bill is available to anyone interested.

In conclusion, the Bipartisan discussion draft advances the development of fundamental housing finance reform. As it proposes, we need to move toward a system with greater private capital at risk, more competition, and more robust risk distribution to achieve sustainable+ home finance for the American people.

Thank you again for the chance to share these views.