“Envisioning a Safe, Sound Mortgage Market for Sustainable Homeownership”

Testimony prepared for

HEARING TITLED

“FUTURE OF THE MORTGAGE MARKET AND THE HOUSING ENTERPRISES”

ON

OCTOBER 8TH 2009,

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

U.S. SENATE

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Thank you, Mr. Chairman and members of the Committee. I appreciate the invitation to testify at today's hearing on the "Future of the Mortgage Market and the Housing Enterprises." It is my honor to be here.

Historically, homeownership for Americans has served as a bedrock of social prosperity. As we consider the future of the mortgage market, we need to step back and understand the sources of the global financial debacle. This is essential as we evaluate the broad options before us of nationalization, privatization, and a public/private system. While Federal support of the mortgage system is now necessary, nationalization is not a long-run solution as it expands taxpayer exposure, while privatization without a stabilizing public role also leads to the inevitable socialization of risk, as this crisis has demonstrated.

This crisis resulted from the explosion of risky mortgages, made in the USA, the result of a lethal race to the bottom for short-term profits, enabled by regulatory failure. This explosion can be traced to the issuance of private label securities. These private label securities were neither standardized nor transparent; they were not traded, and, therefore, they were not subject or accountable to private sector forces of market discipline. The common sense-defying loans they funded, including interest only, negative amortization, zero equity, and teaser rate ARMs, were not designed to be affordable when full rates came into effect; and these loans drove housing markets to an episode of irrational exuberance of historic proportions that has brought down the entire financial system. As these loans were pushed into the market, overall household debt to GDP rose, with the increase coming from mortgage debt and these risky loans.

As non-standard mortgages proliferated, the market share of traditional mortgages declined. From 2000 to their peak in 2006, non-traditional mortgages grew in origination market share from about 10 percent in 2000 to almost 50 percent at their height in 2006. In particular, the housing enterprises' share of the market dropped, as did the market share of the long-term standard fully amortized fixed-rate mortgage that they fund, which I note protects borrowers against interest rate risk, a risk which is likely to be rising.

The fundamental problem in the proliferation of these non-standard loans was the lack of accountability to the long-run risks they generated. Due to the illiquidity of markets, private label mortgage-backed securities did not trade. Because they did not trade, this meant that market discipline could not prevail. They continued to be supplied, eroding mortgage lending standards and artificially pushing up housing prices.

Before private label securities, securitization did work well, supporting sustainable homeownership. Historically, the GSEs were regulated to support sound underwriting. Contrary to popular misconception, they were not allowed to securitize subprime or Alt-A mortgages. After they started losing market share to private label securities, however, shareholder and
other pressures led them to purchase private label securities backed by non-standard mortgages for their portfolio. To be clear, the GSEs did not create the risky mortgage-backed securities that caused the crisis, but they did become a burden to the taxpayer because they were allowed to purchase them for their portfolio after private institutions had manufactured them. My fellow panel member Peter Wallison elsewhere has documented how several GSE observers suggested Congress put limits on GSE portfolios, but to no avail.

To ensure the safety and long-term sustainability of a re-envisioned mortgage finance system, we should pursue policies that embody three principles. First, policies and procedures are needed to identify and prevent out-of-control housing asset bubbles and systemic risk. Loan-to-value ratios, in particular, must be maintained over time.

Second, borrowers must have effective, informed choice: safe mortgages should be the presumed mortgage vehicle for borrowing. The standard mortgage must be a safe mortgage, and mortgage regulation should favor safe products. Consumer choice is inconsistent with heterogeneous non-standard options that cannot be compared by the borrower.

Third, we need a structure that promotes and provides safe and standard mortgages through liquidity and standardization. Effective borrower choice is impacted by the structure of the system. Standard mortgages should be the cost-efficient mortgage. Liquidity in funding sources can assure this.

Securitization should be the way to bring liquidity and cost efficiency to bear on the provision of safe, transparent, and standard 30-year fixed-rate mortgages which banks cannot fund. This can assure effective choice and support for a mortgage system that once again becomes the bulwark of sustainable homeownership in the U.S.

Thank you for the opportunity to be here today, and I will be pleased to answer questions.

[Prepared statement available upon request]
Bibliography


