

Joseph S Tracy: Testimony on Housing Finance Reform – essential elements of a government guarantee for mortgage-backed securities

Testimony by Mr Joseph S Tracy, Executive Vice President of the Federal Reserve Bank of New York, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Washington DC, 31 October 2013.

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Chairman Johnson, Ranking Member Crapo and members of the Committee, thank you for the opportunity to appear before you today. My name is Joe Tracy. I work at the Federal Reserve Bank of New York. Today I will be discussing research¹ in the area of government support for housing finance that colleagues and I at the New York Fed have conducted. It is important for me to emphasize that my remarks today, and the conclusions of the research that I will share with you, represent my own views and are not official views of the New York Fed or any other element of the Federal Reserve System.

I commend the Committee for focusing on the elements necessary to constitute a robust housing finance system in the United States. By “robust” I mean that such a system must provide for the uninterrupted flow of credit to housing markets even in periods of market stress. In the wake of the financial crisis, significant progress is underway to improve the resiliency of financial markets. Nevertheless, we must plan ahead for the risk of future market stresses.

My co-authors and I have started with the observation that in the face of truly systemic housing shocks, governments always intervene. It is not hard to imagine why: given the importance of housing to Americans and our economy, at some level of housing market stress, the government faces intense pressure to take action. We cannot eliminate the risk that the government may have to intervene. So we need to acknowledge that risk and establish a system to reduce and manage it, or we will recreate an implicit guarantee that puts the taxpayer at unacceptable risk.

In my view, the private sector (and the borrower) must absorb all losses up to an agreed point, with the government absorbing all further losses. The level at which the government steps in must be well known in advance and credible to the market, meaning that there should be no speculation as to when and how the government would intervene.

When should the government intervene? If markets believe that the government will intervene sooner than it claims, then this will generate uncertainty, and financial markets will speculate on the timing and nature of the intervention. This uncertainty could have a destabilizing effect, leading to higher losses that the government would ultimately have to absorb. A government guarantee that is unclear or not credible, even if it is explicit and priced, will result in greater costs to the government and, ultimately, the taxpayer.

What should parties pay the government for its willingness to intervene? In my view, the government must determine its exposure net of the loss absorption capacity provided by the private sector. This includes evaluating the counterparty credit risks generated by any risk-sharing transactions. Risk-sharing must require a payment of cash from the private sector and oversight of the capital and overall risk profile of any participants in risk sharing. Of course, the required private capital should be of high quality and should be determined relative to the total risk associated with a given set of mortgage underwriting standards. This may sound complicated, but it is not brain surgery. The government should bear only the cost of extraordinary systemic risks and the private sector must bear losses associated with

¹ [The Capital Structure and Governance of a Mortgage Securitization Utility](#), Federal Reserve Bank of New York Staff Report, Number 644, October 2013.

the normal business cycle. If this can be arranged, then the largest portion of the overall guarantee fee will be priced by the market and not by the government.

An important design decision for a housing finance system is whether the government backstop will apply directly to mortgage-backed securities, their issuers, or some other legal entity. An institution-based program could erode private sector discipline, while a security-based backstop would pick up the idiosyncratic and cyclical risks that are better left to the private sector. Seeking to balance these concerns, I have explored the notion that government support would be triggered by the total losses across an entire group or “vintage” of mortgage-backed securities.

Vintage-based support would likely only be triggered by a true systemic shock. A vintage approach would also provide a transparent and finite maximum loss for the private sector to absorb, supporting robustness at the onset, during, and through the aftermath of a crisis. I believe that the costs of the recent devastating economic downturn would have been far less to the taxpayer, and the housing market would have rebounded far quicker, had a vintage-based program containing adequate high-quality private capital been in effect.

Attracting private capital to finance residential real estate is another important consideration. It is difficult for institutions that depend on short-term funding to take long-term interest-rate risk – for example, the long-term interest-rate risk posed by 30-year fixed-rate mortgages. It is also difficult for investors who do not do the underwriting themselves to take long-term idiosyncratic credit risk. Securitization backed by a predictable level of government support has a useful function in facilitating the allocation of these different risks to different sets of investors through the To-Be-Announced or “TBA” market. I think the TBA market will be key to ensuring Americans’ continued widespread access to the 30-year fixed-rate mortgage.

The TBA market is also important to the role of small banks and lending institutions in a competitive housing finance system. Ensuring an easy, predictable path to securitization of standardized mortgage products is essential to making mortgage credit available throughout our country – in traditionally underserved rural areas and urban areas, and to all sorts of current and potential homeowners, provided by financial institutions of different sizes in different locations. A strong regulator whose primary focus is the housing finance system can also help ensure fair access to smaller institutions.

In summary, it is my personal belief that housing finance reform must incorporate an explicit government backstop accompanied by significant sources of high-quality first-loss private capital. Thank you for the opportunity to appear before you today. I look forward to your questions.