Jerome Powell: The case for housing finance reform

Speech by Mr Jerome H Powell, Member of the Board of Governors of the Federal Reserve System, at the American Enterprise Institute, Washington DC, 6 July 2017.

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Good morning. Thank you to the American Enterprise Institute and Steve Oliner for inviting me here to speak. My topic today is the urgent need for fundamental reform of our system of housing finance—the great unfinished business of post-financial crisis reform.[1]

The Federal Reserve is not charged with designing or evaluating proposals for housing finance reform. But we are responsible for regulating and supervising banking institutions to ensure their safety and soundness, and more broadly for the stability of the financial system. A robust, well-capitalized, well-regulated housing finance system is vital to achieving those goals, and to the long-run health of our economy. We need a system that provides mortgage credit in good times and bad to a broad range of creditworthy borrowers.

While reforms have addressed some of the problems of the pre-crisis system, there is broad agreement that the job is far from done. The status quo may feel comfortable today, but it is also unsustainable. Today, the federal government's role in housing finance is even greater than it was before the crisis. The overwhelming majority of new mortgages are issued with government backing in a highly concentrated securitization market. That leaves us with both potential taxpayer liability and systemic risk. It is important to learn the right lessons from the failure of the old system. We can also apply lessons from post-crisis banking reform. Above all, we need to move to a system that attracts ample amounts of private capital to stand between housing sector credit risk and taxpayers. We should also use market forces to increase competition and help to drive innovation.

The global financial crisis ended in 2009, and the economy has just completed its eighth consecutive year of expansion. We are near full employment. The housing market is generally strong, although it is still recovering in some regions. To preserve these gains, we must ensure the stability of our financial system. With that goal in mind, we are near completion of a comprehensive program to raise prudential standards for our most systemically important banks. But fundamental housing finance reform—including reform to address the ultimate status of Fannie Mae and Freddie Mac, two systemically important government sponsored enterprises (GSEs)—remains on the "to do" list. As memories of the crisis fade, the next few years may present our last best chance to finish these critical reforms. Failure to do so would risk repeating the mistakes of the past.

The pre-crisis system

Congress created Fannie Mae in 1938 and Freddie Mac in 1970. For many years, these institutions prudently pursued their core mission of enhancing the availability of credit for housing. Beginning in the early 1980s, Fannie and Freddie helped to facilitate the development of the securitization market for home mortgages. They purchased and bundled mortgage loans, and sold the resulting mortgage-backed securities (MBS) to investors. Fannie and Freddie also guaranteed payment of principal and interest on the MBS. With this guarantee in place, MBS investors took the risk of changing interest rates, and the GSEs took the risk of default on the underlying mortgages. Thanks to the growth in securitization, these two GSEs have dominated U.S. housing finance since the late 1980s.

The pre-crisis system did its job for many years. By promoting standardization, structuring securities to meet a broad range of investor risk appetites, and issuing guaranteed MBS, Fannie and Freddie brought greater liquidity to mortgage markets and made mortgages more affordable.

But the system ultimately failed due to fundamental flaws in its structure. In the early days of securitization, the chance that either GSE would ever fail to honor its guarantee seemed remote. But the question always loomed in the background: Who would bear the credit risk if a GSE became insolvent and could not perform? Would Congress really allow the GSE to fail to honor its obligations, given the devastating impact that would have on mortgage funding and the housing market? The law stated explicitly that the government did not stand behind the GSEs or their MBS, as Fannie and Freddie frequently pointed out in order to avoid tougher regulation. Nonetheless, investors understandably came to believe that the two GSEs were too-big-to-fail, and priced in an implicit federal government guarantee behind GSE obligations. In the end the investors were right, of course. The implicit government guarantee also meant that investors—including banks, the GSEs themselves, and investors around the world—did not do careful due diligence on the underlying mortgage pools. Thus, securitization also enabled declining lending standards. This was not only a problem of the GSEs—private label securitizations also helped to enable lower underwriting standards.

Over time, the system's bad incentives caused the two GSEs to change their behavior and take on ever greater risks. The GSEs became powerful advocates for their own bottom lines, providing substantial financial support for political candidates who supported the GSE agenda. Legislative reforms in the 1990s and the public/private structure led managements to expand the GSEs' balance sheets to enormous size, underpinned by wafer-thin slivers of capital, driving high shareholder returns and very high compensation for management. These factors and others eventually led to extremely lax lending conditions. The early 2000s became the era of Alt-A, low doc, and no doc loans.[2] These practices contributed to the catastrophic failure of the housing finance system. Almost nine years ago, in September 2008, Fannie and Freddie were put into "temporary" conservatorship and received injections of taxpayer funds totaling $187.5 billion. In the end, the system privatized the gains and socialized the losses.

The buildup of risks is clear in hindsight. But many officials and commentators raised concerns long before the collapse.[3] The long-standing internal structural weaknesses of the old system ultimately led to disastrous consequences for homeowners, taxpayers, the financial system, and the economy.

Reforms to date

Before considering the path forward, it is important to acknowledge that today's housing sector is healthier and in some respects safer than it was in 2005. Although there are significant regional differences, national data show that housing prices have fully recovered from their gut-wrenching 35 percent drop during the crisis. Mortgage default rates have returned to pre-crisis levels. Mortgage credit is available and affordable for strong borrowers.

There has also been meaningful progress in reforming the old system. In 2008, Congress enacted the Housing and Economic Recovery Act, which, among other things, created the Federal Housing Finance Agency (FHFA), modeled on and with similar powers to the Federal Deposit Insurance Corporation. Under the FHFA's oversight, the two GSEs' retained portfolios have declined to about half of their pre-crisis size, and are expected to continue on a downward path. The FHFA and the GSEs have also been working to develop a market for the GSEs to lay off their credit risk. These innovative transactions have raised about $50 billion in private capital that now stands between taxpayers and mortgage credit risk in the GSEs' portfolios. In addition, the creation of a Common Securitization Platform should strengthen the GSEs' securitization infrastructure and facilitate further reforms with an eye toward enhancing competition.

New regulations have also been put in place since the crisis with the goal of encouraging sound underwriting of mortgage loans. Today, lenders must make a good faith effort to determine that the borrower has the ability to repay the mortgage. Moreover, if the lender provides a "qualified mortgage" contract to the borrower, then the lender needs to meet certain other requirements.[4] For example, some contract features such as an interest-only period or negative amortization, where the loan balance increases even though the borrower is making payments, are taboo. Upfront points and fees are limited too.

Today's challenges

These reforms represent movement in the right direction, but leave us well short of where we need to be. Despite the GSEs' significant role in this key market, there is no clarity about their future. When they were put into conservatorship, Treasury Secretary Paulson noted that "policymakers must view this next period as a 'time out' where we have stabilized the GSEs while we decide their future role and structure."[5] Almost nine years into this time out, the federal government's domination of the housing sector has grown and is actually greater than it was before the crisis. Fannie, Freddie, the Federal Housing Administration (FHA) and U.S. Department of Veterans Affairs have a combined market share of about 80 percent of the purchase mortgage market, with the remaining 20 percent held by private financial institutions. After reaching nearly 30 percent of the market before the crisis, private-label securitization has dwindled to almost nothing today.

The two GSEs remain in government conservatorship, with associated contingent liabilities to US taxpayers.[6] Fannie and Freddie have remitted just over $270 billion of profits to the Treasury, more than paying back the government's initial investment. However, under current terms of the contracts that govern their access to Treasury funds, their capital will decline to $0 by January 1, 2018. Today, Fannie Mae and Freddie Mac have more than $5 trillion of MBS and corporate debt outstanding, which is widely held and receives various forms of special regulatory treatment. And because of their scale, these enterprises continue to serve as important standard-setters and significant counterparties to other firms.

While mortgage credit is widely available to most traditional mortgage borrowers, those with lower credit scores face significantly higher standards and lower credit availability than before the crisis. We can all agree that we do not want to go back to the poor underwriting standards used by originators prior to the crisis. But it may also be that the current system is too rigid, and that a lack of innovation and product choice has limited mortgage credit availability to some creditworthy households. According to a survey by the American Banker, in 2016 only nine percent of mortgage originations failed to meet the qualified mortgage contract criteria, down from 16 percent in 2013.[7] The same survey reported that almost one-third of U.S. banks make only qualified mortgage loans, despite the fact that FHA- and GSE-eligible mortgages are exempt from the qualified mortgage requirements until January 2021 or until housing finance reform is enacted, whichever date comes first.

Applying the lessons of banking reform to housing finance

The post-crisis reform program for our largest banks presents an appropriate standard against which the housing finance giants should be judged. After eight years of reform, our largest banking institutions are now far stronger and safer. Common equity capital held by the eight U.S. global systemically important banks has more than doubled to $825 billion from about $300 billion before the crisis. After the crisis revealed significant underlying liquidity vulnerabilities, these institutions now hold $2.3 trillion in high-quality liquid assets, or 25 percent of their total assets. Under rigorous annual stress tests, they must demonstrate a high level of understanding of their risks and the ability to manage them, and must survive severely adverse economic scenarios with high levels of post-stress capital. And they must file regular resolution plans that have made them significantly more resolvable should they fail. These measures were implemented to reduce the risk that a future crisis will result in taxpayer support, and to help ensure that the financial system could continue to function even in the event that one of these banks were to default.

It is ironic that the housing finance system should escape fundamental reform efforts. The housing bubble of the early 2000s was, after all, an essential proximate cause of the crisis. Housing is the single largest asset class in our financial system, with total outstanding residential real estate owned by households of $24 trillion and roughly $10 trillion in single-family mortgage debt.[8] While post-crisis regulation has addressed mortgage lending from a consumer protection standpoint, the important risks to taxpayers and the broader economy and financial system have not been robustly addressed.

The most obvious and direct step forward would be to require ample amounts of private capital to support housing finance activities, as we do in the banking system. We should also strive for a system that can continue to function even in the event of a default of any firm. No single housing finance institution should be too big to fail.

Greater amounts of private capital could come through a variety of sources, including through the entry of multiple private guarantors who would insure a portion of the credit risk, through risk-sharing agreements, or through expanded use of credit-risk transfers. Although private capital must surely be part of the reform effort, there may be limits to the amount of risk that we can credibly expect the private sector to insure. It is extremely difficult to appropriately price the insurance of catastrophic risk—the risk of a severe, widespread housing crisis. Both the private-sector insurance industry and government have struggled with this, particularly with how to smooth the consistent collection of premiums with the irregular payout of potentially enormous losses that may be needed only once or twice in a century. Furthermore, losses can be correlated across asset classes and geographies in these catastrophic events, rendering risk-diversification strategies ineffective. Fannie Mae and Freddie Mac have successfully transferred some credit risk to the private sector, but have thus far avoided selling off much of this catastrophic credit risk, arguing that doing so is not economical.[9]

Principles for reform

After promising legislative initiatives have moved forward but fallen short of enactment, the air is again thick with housing finance reform proposals. As I mentioned at the outset, housing finance reform has important implications for the Federal Reserve's oversight of financial institutions, and for the U.S. economy and its financial stability. While I would not presume to judge these reform proposals, I will offer some principles for reform. These principles are based on the lessons learned from the old system's collapse, and from the experience of post-crisis bank reform.

First, we ought to do whatever we can to make the possibility of future housing bailouts as remote as possible. Housing can be a volatile sector, and housing is often found at the heart of financial crises.[10] Our housing finance institutions were not—and are not—structured with that in mind. Extreme fluctuations in credit availability for housing hurt vulnerable households, reduce affordability and availability, and, as we have seen, can threaten financial stability. As with banks, the goal should be to ensure that our housing finance system can continue to function even in the face of significant house price declines and severe economic conditions. Changing the system to attract large amounts of private capital would be a major step toward that goal.

The question of the government's role in the new system is a challenging one for Congress. Many of the well-known reform proposals include some role for government. Some argue that government cannot avoid bearing the deep-in-the-tail risk of a catastrophic housing crisis. A number of proposals incorporate a government guarantee to cover this risk, to take effect after a significant stack of private capital is wiped out.

That brings me to my second principle: If Congress chooses to go in this direction, any such guarantee should be explicit and transparent, and should apply to securities, not to institutions. Reform should not leave us with any institutions that are so important as to be candidates for too-big-to-fail.

Third, we should promote greater competition in this market. The economics of securitization do not require a duopoly. Yet there is no way for private firms to acquire a GSE charter and enter the industry. This is akin to having only two banks with federal deposit insurance, which would make competition by other banks very difficult. Greater competition would help to reduce the systemic importance of the GSEs, and spur more innovation. Greater competition also requires a level playing field, allowing secondary market access to a wide-range of lenders and thereby giving homebuyers a choice among many potential mortgage lenders and products.

Fourth, it is worth considering simple approaches that restructure and repurpose parts of the existing architecture of our housing finance system. We know that housing reform is difficult; completely redrawing the system may not be necessary and could complicate the search for a solution. Using the existing architecture would allow for a continued smooth, gradual transition.

Fifth and last, we need to identify and build upon areas of bipartisan agreement. In my view, at this late stage we should not be holding out for the perfect answer. We should be looking for the best feasible plan to escape the unacceptable status quo.

Conclusion

I see two reasons why this is a good time to address the housing finance system's shortcomings. First, the economy and the housing sector are healthy. It would be far more disruptive to implement fundamental structural changes during difficult economic times. Second, memories of the crisis are fading. If Congress does not enact reforms over the next few years, we are at risk of settling for the status quo—a government-dominated mortgage market with insufficient private capital to protect taxpayers, and insufficient competition to drive innovation. There is a serious risk, if not a likelihood, that this state of affairs may persist indefinitely, leaving our housing finance system in a semi-permanent limbo. Fortunately, we are blessed with a growing menu of reform options available for public vetting. And there appear to be areas of broad agreement among them. One of those plans, or a combination of different features of various plans, might well suffice to move us to a better system. Housing finance reform will protect taxpayers from another bailout, be good for households and the economy, and go some distance toward mitigating the systemic risk that the GSEs still pose.

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1 The views I express here are my own and not necessarily those of the Board of Governors of the Federal Reserve System.

2 See, for example, Markus K. Brunnermeier, "Deciphering the Liquidity and Credit Crunch 2007–2008," The *Journal of Economic Perspectives*, Vol. 23, No. 1 (Winter 2009), pp. 77–100; Major Coleman IV, Michael LaCour-Little, and Kerry D. Vandell, "Subprime Lending and the Housing Bubble: Tail Wags Dog?" *Journal of Housing Economics,* Vol.17, Issue 4 (December 2008) pp. 272–290; Shiller, Robert J. (2012) *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do about It,* Princeton, New Jersey: Princeton University Press; E. Pinto (2015), "Three Studies of Subprime and Alt-A loans in the U.S. Mortgage Market," American Enterprise Institute (January 2015), www.aei.org/wp-content/uploads/2014/09/Pinto-Government-Housing-Policies-in-the-Lead-up-to-the-Financial-Crisis-3-Studies-1.6.15.pdf.

3 See, for example, Alan Greenspan, "Government-Sponsored Enterprises," remarks delivered at the Conference on Housing, Mortgage Finance, and the Macroeconomy, Federal Reserve Bank of Atlanta, May 19 2005, www.federalreserve.gov/boarddocs/speeches/2005/default.htm; and Randal Quarles "Remarks Before the Women in Housing and Finance," June 13, 2006.

4 More specifics on the features required for qualified mortgage contracts are available at www.consumerfinance.gov/askcfpb/1789/what-qualified-mortgage.html.

5 Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers, September 7, 2008, www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx.

6 The size of these contingent liabilities is potentially quite large. FHFA's stress test results published in August

2016 found that under its severely adverse scenario the two GSEs could need to draw up to $125.8 billion from the U.S. Treasury. See www.fhfa.gov/AboutUs/Reports/ReportDocuments/2016_DFAST_Severely-Adverse-Scenario.pdf.

7 American Bankers Association, “24th Annual ABA Residential Real Estate Survey Report,” (March 2017), www.aba.com/Press/Documents/2017ABARealEstateLendingSurveyReport.pdf.

8 Based on information contained in the Financial Accounts of the United States available at www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm.

9 See “Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions,” FHFA (August 2015). The overview differentiates between expected loss (credit losses that would be projected to occur even under a stable baseline), unexpected loss (losses that might occur under a stressful but plausible event such as recession) and catastrophic loss (losses beyond those of an unexpected loss and that are deemed highly unlikely to occur). The overview notes that “ catastrophic risk events are deemed so unlikely, meaning they present so little risk, that the Enterprises have found it to be too costly (not economical) to transfer much of this risk to the private sector," www.fhfa.gov/aboutus/reports/reportdocuments/crt-overview-8-21–2015.pdf.

10 See for example Carmen M. Reinhart and Kenneth S. Rogoff, “The Aftermath of Financial Crises,” American Economic Review, vol. 99 (May 2009) pp. 466–72; Òscar Jordà, Moritz Schularick, and Alan M. Taylor, “The Great Mortgaging: Housing Finance, Crises, and Business Cycles,” NBER Working Paper No. 20501 (September 2014), www.nber.org/papers/w20501; and the International Monetary Fund, “Housing Finance and Financial Stability – Back to Basics?” Global Financial Stability Report (April 2011), www.imf.org/en/Publications/GFSR/Issues/2016/12/31/~/media/Websites/IMF/imported-flagship-issues/external/pubs/ft/GFSR/2011/01/pdf/_chap3pdf.ashx.