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TOWARD A THREE TIERED MARKET FOR US HOME MORTGAGES

by Robert C. Pozen*

Executive Summary

1. Home ownership has both positive and negative externalities, so we need to be careful in designing governmental subsidies for home ownership. Unfortunately, most of the current US subsidies for home ownership are not very effective, and some of these subsidies increase the default rate on home mortgages – a key negative externality.

2. The mortgage interest deduction (MID) is not well designed to promote home ownership and costs roughly $100 billion per year in lost tax revenues. To reduce the costs of the MID and strengthen its link to home ownership, Congress should:
   a. eliminate the MID for second homes and home equity loans; and
   b. provide a tax credit for mortgage interest on a primary residence, or reduce the ceiling on the MID from $1 million to $500,000 per couple.

3. Some states prohibit lenders from going after personal assets in collecting deficiencies after mortgage foreclosures. These states laws encourage home owners to make low down payments and walk away from "underwater" mortgages – when the mortgage amount exceeds the current value of the property. Therefore, Congress should:
   a. supersede state laws prohibiting personal recourse on mortgages, and
   b. allow individual hardship cases to be adjudicated by bankruptcy judges.

4. The FHA and VA programs for insuring home mortgage require minimal down payments, and set limits based on mortgage size rather than family income. Therefore, Congress should:
   a. gradually raise the down payment requirement for these programs to a reasonable percentage of the purchase price, and
   b. establish an income limit for these programs such as the median income level for the metropolitan area.

5. Ginnie Mae, a federal agency, that is part of HUD, already does a good job of securitizing mortgages insured by the federal government.
   a. If Congress decides to expand federal subsidies for home mortgages, it should do so through direct appropriations reflected in the federal budget.
   b. If Congress decides to provide government support for the securitization of these other mortgages, it should do so through Ginnie Mae.

6. Fannie Mae and Freddie Mac should be phased out gradually, by reducing the maximum size of conventional mortgages they may purchase. Most of their governmental subsidies have gone to shareholders and executives of these two corporations, and little has gone to homeowners.
   a. Government subsidized mortgages should be securitized through Ginnie Mae – priced accurately and included in the federal budget.
   b. Conventional mortgages should be securitized through the private sector, with appropriate reforms.

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c. The Federal Reserve should provide liquidity to the mortgage securities market, if and when necessary.

7. To revive the private market for mortgage-backed securities (MBS), federal regulators should adopt a combination of measures.
   a. Regulators should adjust capital requirements of bank sponsors of MBS to reflect the actual allocation of risks in these deals.
   b. Regulators should require more disclosure on the individual loans in the pools supporting MBS, and encourage simpler structures for MBS deals.
   c. Regulators should minimize ratings shopping by allowing an independent party to choose the ratings agency for large structured finance deals.

8. Congress has created a middle tier of MBS, above the private market but below the government guaranteed market, for qualified residential mortgages (QRMs). Since MBS based solely on QRMs would be exempt from risk retention requirements and other protections, regulators should mandate high downpayments and strict underwriting standards for QRMs.

9. In addition, the criteria for QRMs should be designed to:
   a. Phase out Fannie Mae and Freddie Mac by limiting the QRM status of their mortgages to a specific numbers of years;
   b. Promote long-term fixed-rate mortgages by allowing prepayment penalties for the initial 5 years of high-quality mortgages; and
   c. Increase the standardization of home mortgages in the US, including flexibility for mortgage servicers to modify loans in appropriate circumstances.

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Introduction

Home mortgages constituted the single largest type of credit in the US at $10.6 trillion as of September, 2010. Almost half of this amount took the form of mortgage-backed securities (MBS) that were effectively guaranteed by the US government -- $2.55 trillion by Fannie Mae, $1.7 trillion by Freddie Mac and $1 trillion by Ginnie Mae. The other half was composed of $1.557 trillion in MBS not backed by the US government and $3.837 trillion in whole mortgage loans.[1]

Since the financial crisis started in 2007-2008, however, the annual flow of new home mortgages has shifted even more to the public sector from the private sector. In 2006, only 5% of home purchase mortgages originated were insured by the Federal Housing Administration (FHA), and less than another 5% were originated through the insurance programs at the Veterans Administration (VA) and US Department of Agriculture (USDA). By contrast, these three agencies together insured close to half of all home purchase mortgages originated in 2009 – 38.8% for FHA, 7% for VA and 7% for USDA.[2]

Similarly, the government's role in issuing MBS soared from 2006 to 2009. Many of the government-insured mortgages mentioned above are securitized by Ginnie Mae, part of HUD. Ginnie Mae's share of new MBS originators rose from 4% in 2006 to 25% in 2009. Private lenders may sell their conventional mortgages (not government insured) up to a specified size to either of two government-chartered corporations, Fannie Mae and Freddie Mac, which were put into conservatorship by the US government in September of 2009. The portion of MBS issued by these two corporations was 72% in 2009, up from 40% in 2006. Ginnie Mae, Fannie Mae and Freddie Mac together accounted for 97% of all MBS issued in 2009.[3]

During the same period, the securitization of US home mortgages by the private sector plunged. In 2006, the private sector securitized $723 billion in home mortgages, including $154 billion in subprime mortgages. In 2009, the private sector was estimated to securitize a total of only $48 billion, with only one small deal for subprime mortgages.[4]

In short, by 2009, the US home mortgage market was totally dependent on government insurance programs and purchases of mortgages. In 2010, 95% of all home mortgages originated in the US were either insured by a federal program or purchased by Fannie Mae or Freddie Mac.[5]

Nevertheless, none of the 2,400 pages of the Dodd-Frank Act, passed in the summer of 2010, attempted to reform these two corporations; the Act "kicked the can down the road" by directing the Administration to publish proposals on this subject by the end of January, 2011. Instead, the statute contains a 5% requirement for risk retention – subject to regulatory exemptions – by certain originators and securitizers of mortgages. It also establishes tougher rules for credit rating agencies and stricter standards for private mortgage products.

Given the enormous problems in the US market for home mortgages and the modest legislative response to date, this paper will address the key policy issues related to governmental support of home mortgages in four main parts. Part I begins by tackling the fundamental question of whether governmental subsidies are necessary to promote the social benefits of home ownership. It reviews the

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evidence in the US and other similar countries – such as Australia, Canada and England – which have higher homeownership rates than the US with much lower levels of government subsidies. Part I concludes that some US subsidies like the mortgage interest deduction are generally not effective at increasing home ownership, and other US subsidies like minimal down payments undermine the social benefits from home ownership. Nevertheless, Parts II, III and IV are based on the premise that the US politically will decide to continue subsidizing a significant number of home mortgages.

Part II critiques the current approach of the government mortgage insurance programs – with their emphasis on the amount of the home's purchase price and the minimal requirements for down payments. Instead, Part II proposes new criteria, based primarily on homeowner income, to allocate government subsidies for home mortgages. It also argues that federal support for mortgage securitization would be more efficiently implemented directly through Ginnie Mae, than indirectly through Fannie Mae and Freddie Mac where only a small portion of the federal subsidy actually gets to homeowners.

Recognizing that the revival of the private market for home mortgages is necessary to reduce the degree of government mortgage support, Part III recommends the adoption of specific measures to revive this private market. It advocates more realistic capital requirements for bank sponsors of MBS based on the actual allocation of risks, and simpler deal designs that would be easier for investors to analyze. To help rebuild investor confidence in bond ratings, it suggests an innovative procedure that would minimize ratings shopping without government rate setting.

Part IV explains how the exemption for "qualified residential mortgages" (QRMs) from the risk retention requirements of the Dodd Frank Act will create a middle tier of MBS between the private sector and the government-subsidized sector. It maintains that this exemption should be narrowly defined, to avoid a repetition of the abuses resulting from the originate-to-distribute model. It also suggests that the exemptive criteria should be designed to promote a viable market for fixed-rate mortgages while gradually reducing the role of Fannie Mae and Freddie Mac.

I. Societal Justifications for Promoting Home Ownership

Why does the US government supply so many subsidies to promote home ownership? For this purpose, a subsidy includes any benefit or protection beyond that provided by the private market. Such a subsidy includes direct governmental appropriations as well as lower-than-market interest rates, minimal down payments on government-insured mortgages, tax deductions for mortgage interest and property taxes, capital gains exemptions on home sales, government institutions to buy or securitize home mortgages, and personal immunity against deficiencies in home mortgage foreclosures.

Part I starts by outlining the positive and negative externalities associated with home ownership. Although homeownership does have substantial social benefits, certain types of government subsidies magnify the negative externalities of home ownership. Then Part I reviews the practical impact of the tax deduction for mortgage interest – one of the most important governmental tools for promoting home ownership. Yet this tax deduction has minimal effects on home ownership in some areas, and positive effects mainly for well-off families in other areas. Part I ends by reviewing the relationship between home ownership and governmental subsidies on an international basis. It shows that many Anglo-Saxon countries achieve higher levels of home ownership than the US without most of the governmental subsidies.

A. Externalities of Home Ownership

Governmental subsidies for home ownership are typically justified by their benefits to the rest of society. For example, home ownership is strongly connected to better maintenance of the house and garden, as well as higher levels of participation in civic and political groups.[6] Other people are willing to pay more to live near home owners because of their beneficial effects on the local neighborhood.[7] Coulson (2001). In other words, government support of home ownership for certain families bestows social benefits on the larger community.

On the other hand, certain aspects of home ownership are closely associated with negative externalities, though these have been much less studied. For instance, Professor Paul Krugman has suggested that high levels of home ownership impose social costs because home owners are less mobile than renters.[8] This reluctance to move to a different location for a new job reduces to some degree the efficient functioning of labor markets.

More importantly for the financial crisis, researchers have shown that mortgage defaults and home foreclosures have a significant adverse impact on other homes in the neighborhood. For instance, researchers have estimated that a single foreclosure decreases values of nearby houses by as much as 1%.[9] This occurs because the foreclosed home is quickly sold at a very low price, or the foreclosed house remains a vacant eyesore.

Thus, if government subsidies intended to promote home ownership in practice increase the level of mortgage foreclosures, these subsidies will have negative social externalities. The main culprit has been a well-intentioned drop in the down payment requirement for certain types of mortgages, together with lax underwriting standards. In 2005 and 2006, for example, 40% of all first-time buyers took out mortgages with no down payment.[10] Yet we know that having no equity in a home is the single best predictor of mortgage defaults.[11] When housing prices turn down or other problems arise, it is very easy for homeowners with negative equity to simply walk away from their mortgages.

Home buyers are more likely to have no equity in their homes, and therefore more likely to default, in states that limit the ability of lenders to attach the personal assets of borrowers to satisfy

deficiencies after mortgage foreclosures.[12] In states like California and Arizona, the borrower is not personally liable for any shortfall if the lender forecloses on a home and sells it for less than the outstanding mortgage amount. In states like Florida and Nevada, "homestead" exemptions generally prevent creditors from reaching owner-occupied homes to satisfy mortgage deficiencies of homeowners. Although correlations are not necessarily causations, the percentage of "underwater" mortgages – with outstanding amounts above the current value of their homes – far exceeded the national average in all four states.

In summary, we should carefully design any subsidies to promote the positive, and not the negative, externalities associated with home ownership. Although low down payments encourage home ownership, they increase the adverse neighborhood effects of mortgage defaults and foreclosures. Given the strong correlation between mortgage defaults and negative home equity, we should move away from government-supported mortgages with minimal down payment requirements. Instead, we should gradually increase down payment requirements for such mortgages and adopt realistic income standards for such mortgage holders to avoid defaults – even if housing prices fall in the future.

Similarly, states should repeal blanket protections against personal recourse on home mortgages – legal immunity for home owners who default on their mortgages and their homes are sold in foreclosure for less than the outstanding mortgage amount. Non-recourse mortgages increase the number of defaults with their negative externalities. Non-recourse mortgages also encourage people to walk away from mortgages that they could afford to pay.

Nevertheless, there may be individual cases where a homeowner does not have sufficient personal resources to pay a deficiency after a mortgage foreclosure. These situations should be addressed by bankruptcy courts, which are in the best position to evaluate the overall financial situation of the borrower. In specific, states should recognize a home mortgage as a senior lien on the property and an unsecured claim to the extent that the proceeds from sale of the property are less than outstanding mortgage. Thus, the lender could enforce this unsecured claim for such a deficiency against a former homeowner, who could in turn choose to file for bankruptcy. Then the judge could decide to eliminate, reduce or reschedule this unsecured claim in light of the total creditor claims against the borrower and his or her financial resources. [13]

B. Tax Deductions for Mortgage Interest

One of the largest subsidies for home ownership in the U.S. is the income tax deduction for interest paid on home mortgages. Each year the US government loses approximately $100 billion in tax revenues due to this deduction.[14] Furthermore, some states allow income tax deductions for interest paid on home mortgages.

The parameters of this federal tax deduction are quite broad: it is allowed for interest paid on all home mortgages – including vacation cottages and other second homes – with principal totaling up to $1 million per couple. In addition, a couple may deduct interest on a home equity loan up to $100,000. A home equity loan is typically a second mortgage on a home that already has a first mortgage – even if the loan proceeds are not used to buy or improve the home. These deductions for mortgage interest, including interest on home equity loans, are available to all home owners who itemize their tax deductions, instead of taking the standard deduction.

Nevertheless, as explained below, despite the magnitude and breadth of the mortgage interest deduction, it does not promote home ownership in most locations. And in those locations where the tax deduction does promote home ownership, it does so mainly for high-income families.

The actual impact of the mortgage interest deduction depends heavily on the nature of the local market for home mortgages. In "tightly regulated" markets with limited vacant land and strict land use controls, such as Boston, Massachusetts, the mortgage interest deductions tends to raise the price of homes, rather than the quantity of home ownership. In other words, when the supply of prime residential lots is relatively inelastic, an increase in demand through tax deductions will have price rather than quantity effects. For this reason, researchers have found that the elimination of the income tax deductions for mortgage interest and property taxes would reduce home prices by 2% to 13% depending on the metropolitan area.[15]

By contrast, we would expect the mortgage interest deduction to increase the quantity of homeowners in "loosely regulated" markets (e.g., Houston, Texas), where there is ample supply of residential lots and the land use controls are relatively light. In loosely regulated markets, however, it is unclear in theory what would be the distributional effects of the mortgage interest deduction. On the one hand, this deduction benefits only the one third of taxpayers who itemize, mainly from the top half of all filers, who buy relatively pricey homes.[16] On the other hand, it seems logical that the decision to purchase a home is much less influenced by housing prices for high-income families than low-income families.

In a recent paper, Hilber and Turner resolve these theoretical arguments through an extensive empirical analysis of metropolitan areas in the US.[17] In tightly regulated markets, they conclude that mortgage tax subsidies have a significant adverse impact on homeownership: "they reduce the likelihood of homeownership, with the effect being slightly more negative for moderate income households (-3.7 percentage points) than high income households (-3.4 percentage points)."[18] In loosely regulated markets, they conclude that the mortgage interest deduction "has a positive effect on home ownership attainment, but only for higher-income groups, increasing their likelihood of home ownership by about 3.6 to 5 percentage points depending on income status, with the effect being stronger for higher-income than moderate households."[19] Finally, they conclude that the mortgage interest deduction had no impact on low-income families in either tightly or loosely regulated housing markets.

These conclusions suggest the need for fundamental rethinking on whether the mortgage interest deduction is justified as promoting home ownership. A positive effect on home ownership is achieved only in loosely regulated housing markets; in tightly regulated housing markets, this deduction significantly decreases the level of home ownership. Moreover, the positive effects of this deduction are highly skewed in favor of home ownership for high-income families: it has little impact on home ownership for low-income households since they do not itemize their deductions.

If we wanted to promote home ownership for low-income and moderate-income families, we would transform the interest deduction into a tax credit. A tax credit – e.g., equal to 20% of the interest payments on a home mortgage – would be much more effective than a tax deduction in moving families at these income levels from renters to home owners. According to one study, transforming the mortgage interest deduction into a tax credit on a revenue neutral basis would increase the national homeownership rate by 3%.[20] But this transformation may not be politically feasible.

Alternatively, Congress could adopt either or both of the following measures, which would help reduce the budget deficit without reducing home ownership for low income and middle income families.

First, Congress could limit the interest deduction to the mortgage on a couple's primary residence -- in other words, no interest deductions for vacation or second homes. Second, Congress could limit the interest deduction to home mortgages up to $500,000 – down from the current maximum of $1 million. Both these measures were contained in the proposals by the Co-chairs of President Obama's deficit reduction commission. [21]

In addition, the co-chairs proposed to eliminate the current interest deduction for home equity loans up to $100,000. This aspect of the interest deduction cannot be justified as promoting home ownership, since the proceeds of home equity loans are rarely used to improve homes. These proceeds are often used to purchase goods, pay tuition or reduce credit card debt. However, these uses of home equity loans are inconsistent with the Congressional decision several years ago to eliminate tax deductions for interest on consumer loans.

Of course, all these proposals should be implemented gradually over many years to prevent a major blow up in the US market for homes. For the 12 years before 2000, the UK gradually eliminated its tax deduction for mortgage interest without a material impact on its home ownership rate.[22] Over the long run, it is estimated that these three proposals together would reduce the federal deficit by roughly $15 billion per year.[23]

C. International Perspective on Home Ownership

The tax deduction for mortgage interest is just one of many US subsidies to promote home ownership. In this paper, we have already mentioned three others: government insurance of FHA, VA and USDA home loans; government-backed purchase and securitization of home mortgages; and no personal recourse for deficiencies on home mortgage foreclosures.

Table I sets forth an international comparison on these four types of homeownership subsidies for the US and five other advanced industrial countries, together with their homeownership rates expressed as a percentage of families owning a home. Three of these comparison countries – Australia, Canada and the UK – were chosen because they, like the US, have an Anglo-Saxon legal system. The two remaining comparison countries – France and Germany – were chosen because they are the largest European countries and both have legal systems based on civil law.

A review of the data in Table I reveals several important differences among these countries:

- None of these five comparison countries allows tax deductions for mortgage interest, and none offer non-recourse mortgages to home buyers.
- Only Canada and the US have established government programs for mortgage insurance and mortgage securitization.
- Yet the home ownership rate of all three Anglo-Saxon countries was slightly higher than that of the US, while the home ownership rate of France and Germany was much lower than the US rate.

These factual differences strongly suggest that the broad array of US subsidies for homeownership are not essential to promoting high rates of homeownership. This is the key lesson from the comparison between the US and the three Anglo-Saxon countries. But the differences in homeownership rates between these three Anglo-Saxon countries and the two civil law countries show that other types of factors are at work. For instance, the UK and Germany both do not provide significant monetary subsidies for homeownership, so the 22% difference in home ownership rates

between these two European countries must be attributable to factors such as cultural preferences, historical patterns and legal traditions.

Since international comparisons like the one above are inherently superficial, it is helpful to take a deeper look at the differences between the US and Canada – the country whose housing system is most similar to that of the US. (A detailed description of the Canadian mortgage market is contained in the source cited in the footnote).[24] Of course, there are many differences between Canada and the US with respect to tax rates and income distribution. Nevertheless, it is surprising that Canada has achieved a slightly higher rate of home ownership than the US without most of the subsidies in Table I. This comparison suggests that many of the US subsidies for homeownership may raise the price of American homes rather than increase the homeownership rate.

In the private market, Canadian lenders have traditionally required down payments of 20% or more of home's purchase price. Canadian lenders also have recourse against personal assets in the event of a foreclosure deficiency. Although American lenders once insisted on a similar down payment level, they substantially dropped their down payment standards in the years leading up to the financial crisis. The combination of low down payments and no personal recourse on foreclosure deficiencies led to very high levels of mortgage defaults in the US when housing prices plummeted.[25] This comparison suggests that no down payment and no recourse mortgages may decrease, rather than increase, promote home ownership in the long term.

In the public sector, Canada has relatively small programs for government insurance and securitization of home mortgages, though these programs have grown rapidly over the last few years. Moreover, these governmental programs now require down payments of at least 5% of a home's purchase price, together with private mortgage insurance for another 15%. As a result, the default rate for mortgages in these Canadian programs has been much lower than the default rate in their American counterparts. Thus, the Canadian example demonstrates that large public programs, which allow home purchasers to obtain mortgages with little private equity, are not necessary to achieve high rates of homeownership.

Part II: The Who and How of Federal Mortgage Subsidies

As discussed in Part I, since homeownership has both negative and positive externalities, we should carefully design any governmental subsidies for homeownership. The interest deduction for home mortgages in the US, for example, has an adverse impact on homeownership in many metropolitan regions, and does not promote homeownership for low-income families in any region. The homeownership rate in the US is lower than the rate in Australia, Canada and the UK, despite much lower subsidies for home mortgages in all three countries.

Nevertheless, given the political support for homeownership in the US, Congress will almost certainly maintain certain types of subsidies for home ownership. In Part I, we recommended narrowing the scope of the mortgage interest deduction and reducing state support of no-recourse home mortgages. In Part II, we will suggest stricter limits on the FHA, VA and USDA programs for insuring home mortgages, and a much smaller role for the federal government in securitizing home mortgages.

A. Federal Insurance Programs for Home Mortgages

The federal government insures mortgages issued by private lenders against losses on default through three main programs – FHA, VA and USDA. Eligibility for all three programs is limited by the dollar amount of the mortgage, with minimal down payment requirements. We suggest eligibility criteria more geared to homeowner income, with a gradual phase-in of higher down payment requirements.

1. Critical Review of Existing Programs

FHA is the largest federal program for home insurance. As mentioned before, FHA insured almost 40% of the US home purchase mortgages in 2009. The reserves for this program have dropped below the statutory requirement of 2% of outstanding loans insured. While FHA officials believe its home insurance program has enough cushion to stay solvent, even some of them admit that the program could need a federal bailout if housing prices remain depressed.[26] To remain solvent, the FHA is raising its fees to home borrowers. In April of 2010, FHA increased the upfront fee from 1.75 to 2.25% of the insured mortgage since FHA could not change the annual premium without legislation. In October of 2010, Congress increased the annual premium from 0.50% - 0.55% to 0.85 – 0.90% of the insured mortgage, so FHA reduced the upfront fee to 1%.

Yet the minimum down payment for a FHA mortgage is still set by Congress at 3.5% of the insured mortgage amount. Moreover, the FHA website touts several federal programs for down payment assistance – Nehemiah grants up to 3% towards down payment, HART grants up to $15,000 towards down payment and closing costs, and Neighborhood Gold Grants which allow "homebuyers to purchase a home with no down payment and no closing costs by providing the money necessary to purchase without repayment." [27] In addition, the FHA website lists various state and city programs for down payment assistance – such as Access 2000, a no money down program for California.

Beside this minimal requirement for down payments, the FHA insurance program is limited by the dollar amount of the mortgage. The standard FHA mortgage limit is $417,000 for one-unit dwellings, with a floor of $271, 050 based on local prices in lower cost areas. However, the effective ceiling for FHA-insured mortgages of one-unit dwellings is $625,500 in most high cost areas, (temporarily raised to $729,750 from 2008 thru 2011) and $938,250 in a few extremely high cost areas such as Alaska and Hawaii.

The FHA imposes no income limit on homebuyers who want to participate in mortgage insurance program. While the FHA does review whether the home buyer has the financial capacity to meet his or her mortgage payments, it does allow more flexibility in calculating household income and payment ratios than conventional mortgages.[28]

The VA mortgage insurance program is even more favorable to home buyers than the one run by the FHA.[29] The VA allows an eligible buyer to finance 100% of the purchase price of his or her home through a mortgage issued by a private lender. In other words, no down payments are required for VA-insured mortgages. The borrower pays the VA an upfront insurance fee of 2.15% of the mortgage amount, though no annual insurance fee. The upfront insurance fee may be financed as part of the VA-insured mortgage. In addition, the VA allows the seller of the home to contribute 3% to 6% of the purchase price to offset the buyer's closing costs.

In 2010, the maximum guaranty amount for a VA mortgage was 25% of the local VA limit. The highest local limit was $625,000. Therefore, the maximum mortgage amount for a VA-insured mortgage was $625,000, of which the VA would insure $156,250 against losses on default.

Under the VA's rules, no more than 41% of a home buyer's income can be devoted to mortgage payments and other housing costs such as property taxes and fire insurance. But the VA has no upper limit on the homeowner's overall income. Instead, it focuses on whether the homeowner can demonstrate enough qualifying service in the US armed forces.[30]

Like VA-insured home mortgages, mortgages insured by the USDA do not require any down payments and allow sellers to help pay the buyer's closing costs. Similarly, the USDA charges an upfront insurance fee, which can be financed as part of the mortgage, though no annual insurance fee.[31]

In contrast to the VA program, the USDA program has an upper income limit for eligibility – 115% of the median income for the area. But the USDA program has no maximum for either the purchase price of the home or the size of the mortgage.

The USDA program is intended mainly to encourage homeownership in "rural" areas. Nevertheless, the General Accounting Office found 1,300 instances of "rural" areas that were closely integrated with urban areas. For example, Belpre, Oho was considered "rural" by the USDA in 2005. In that same year, the US Census reported the Belpre was "densely settled" with 1,000 residents per square mile, and that it was contiguous to the urban community of Parkersburg, West Virginia, with a population of 33,000.[32]

2. A Different Approach to Government Mortgage Insurance

The cost of government mortgage insurance is substantially below its cost in the private sector. The private sector also charges upfront and annual premiums for mortgage insurance, while the VA and USDA programs do not charge annual premiums. Moreover, private mortgage insurance imposes stricter underwriting standards than its government counterparts. In short, government insurance of home mortgages constitutes a significant public subsidy to promote homeownership.

Should US taxpayers subsidize a $617,600 mortgage on a $640,000 home for a family with a joint income of $400,000 per year? Even worse, should US taxpayers be subsidizing a $625,000 mortgage for a $625,000 home for a couple with a joint income of $625,000 per year? These examples can occur because both the FHA and VA have no maximum limits on homeowner income, just maximum

limits on the size of the insured mortgage. Only the USDA program has limits on homeowner income, though not on size of the insured mortgage.

In my view, the key criterion for all government insured mortgages should be homeowner income below a specified level – e.g., below the median income for the metropolitan region. If we want to promote homeownership, we should focus our limited public resources on those least likely to buy homes without government assistance. Under current law, by contrast, the largest public support for homeownership – the tax deduction for mortgage interest – does not generally benefit low or moderate-income families because they do not itemize deductions. Even if Congress were to limit this tax deduction to one mortgage on a primary residence up to $500,000, as suggested above, this tax deduction would still not benefit low or moderate-income families since they do not itemize.

If Congress adopted a relatively modest income limit for government insurance of home mortgages, it may not be necessary to have a size limit on insured mortgages. Nevertheless, to avoid unforeseen consequences, Congress should also set a size limit – such as the median price of a home in a metropolitan region not to exceed $350,000 (indexed to inflation in the future). In light of the looming federal budget deficits, it is hard to justify federal subsidies (i.e., below market rates) for home mortgages over $500,000 even in relatively expensive cities.

Most importantly, Congress should gradually raise the down payment requirements for all federal mortgage insurance, and eliminate the various methods (e.g., grants or sells contributions) to avoid these requirements. As discussed above, the best predictor of mortgage defaults is negative equity. When home purchasers begin with minimal down payments, they will quickly have negative equity in their homes if local prices fall. A mortgage default not only causes tremendous personal problems for the homeowner, but also imposes substantial social costs on the neighborhood, as explained above.

Of course, we need to proceed cautiously on raising down payment requirements, given the fragility of the current housing market. Therefore, we should announce a schedule for incremental increases over the next decade. For example, we could increase by 0.5% per year the down payment requirement for home mortgages in all federal insurance programs until it reaches 8.5% of a home's purchase price.

B. The Government's Role in Mortgage Securitization

Beside insuring mortgages through FHA, VA and USDA, the federal government has supported home mortgages by chartering two shareholder-owned corporations, giving them special privileges and directing them to purchase a specified percentage of low and moderate-income mortgages. This percentage was gradually increased from 42% in 1996 to 56% by 2008, and this category was explicitly defined to include subprime mortgages.[33]

To facilitate their purchases of low and moderate-income mortgages, Congress exempted from state and local income tax the interest payments on the debt securities issued by Fannie Mae and Freddie Mac. Congress also granted them a $2.25 billion line of credit from the US Treasury. In addition, both these corporations did not have to register with the SEC their public offerings of securities, which could be acquired without limit by FDIC-insured banks.[34]

Because of these privileges normally associated with a federal agency, the bonds of Fannie Mae and Freddie Mac were widely perceived by investors to constitute the moral – though not legal – obligations of the US. Due to this perceived implicit guarantee, the interest rates on the bonds of

both corporations were significantly lower than those of other top rated financial institutions. However, Fannie Mae and Freddie Mac bonds were not subject to the statutory ceiling on federal debt. In 2007, the debt of these two corporations was $5 trillion, roughly equal to the total US Treasury debt held by investors in that year.[35]

Fannie Mae and Freddie Mac issued so much debt in part to build up their own portfolios through huge purchases of MBS from the secondary market. In effect, these corporations used their implicit federal guarantee to borrow cheaply, buy MBS for their own portfolios and profit from the spread. The portfolios of Fannie Mae and Freddie Mac peaked in 2004 at $1.6 trillion, and have stayed below that level in response to public criticism.[36] There is now a strong consensus against Fannie Mae and Freddie Mac issuing bonds to finance the purchase of MBS for their own portfolios.

The debate is now centered on whether Fannie Mae and Freddie Mac should continue in their role as mortgage securitizer -- purchasing mortgages from the private sector, turning these mortgages in MBS, and selling these MBS with guarantees to the investing public. Let us consider the four main arguments for allowing Fannie Mae and Freddie Mac to continue playing this role.

1. Subsidizing home mortgages for needy families

As explained above, FHA, VA and USDA already subsidize home mortgages through below - market insurance in certain circumstances. As suggested above, these programs should be limited to needy families with incomes below specified levels (as well as meeting other relevant standards). Without Fannie Mae or Freddie Mac, we can focus these mortgage insurance programs on helping needy families as we choose to define them.

In addition, the federal government offers needy families other types of assistance in purchasing homes. These include HUD's interest subsidies for loans and direct loans from financial agencies to first time homeowners. These other programs can target needy families better, and provide assistance to them more efficiently, than Fannie Mae or Freddie Mac.

2. Guaranteeing MBS sold to public investors

As mentioned before, Ginnie Mae currently securitizes only mortgages insured by the FHA and other federal agencies. To the extent that Congress decides to subsidize other types of home mortgages for needy families, it should do so directly through on-budget appropriations. These other home mortgages can also be securitized by Ginnie Mae if desired by Congress. As a federal agency under HUD, Ginnie Mae is an appropriate and effective securitizer of home mortgages subsidized by the federal government. Ginnie Mae's guarantee of mortgage securities should be aimed at covering its costs, and its finances should be included in the federal budget.

Mortgage bankers have suggested that a federal agency like Ginnie Mae purchase and securitize conventional mortgages – not insured by any federal program. As part of this process, they want this federal agency to provide private lenders with a guarantee against default of home mortgages meeting the criteria now used by Fannie Mae and Freddie Mac.[37] In other words, since Fannie Mae and Freddie Mac went bankrupt with their implicit federal guarantee of conventional home mortgages, we should move to an explicit federal guarantee of such mortgages.

However, why should the federal government directly or indirectly guarantee MBS for homeowners with incomes above whatever criteria are chosen to define needy families? In my view, the securitization of these home mortgages for middle and higher income families should be left to the private sector. Of course, private sector securitization will mean less favorable rates and terms for these

home mortgages than those eligible securitizations by Ginnie Mae. But most of these homeowners already receive governmental support through the interest deduction on their mortgages.[38]

The main argument against my view is that mortgage securitization in the private sector has virtually stopped since the financial crisis. In part, this has happened because Fannie Mae and Freddie Mac have been so active in buying home mortgages from private lenders – up to $729,000 in amount. No private party can compete with these two corporations now that the federal government explicitly backs their guarantees. In part, this has happened because investors have lost confidence in private sector securitization after the huge spike in defaults during the financial crisis. Part III of this paper we delineates the reforms needed to revive private securitization of home mortgages.

3. Attraction of more capital to the mortgage markets

Some commentators would leave the allocation of mortgage capital to the normal functioning of the financial markets. In their view, capital would be attracted to home mortgages to the extent doing so would be more profitable than competing uses of capital. If excess capital is drawn into home building as a result of governmental subsidies, they would argue, then such capital is being taken away from more productive uses for the American economy.

Other commentators would counter with the argument that mortgages are special due to the societal goal of promoting home ownership. In their view, the market left alone might not allocate enough capital to support that goal. This latter view underlies the case for Fannie Mae and Freddie Mac as shareholder-owned corporations with special privileges tied to serving the US mortgage market. By selling debt securities to the public and buying mortgages, these two corporations bring more capital into the mortgage market.

However, even if we decide to attract more capital to building homes, the structure of these two corporations does not meet the cost-benefit test. The implicit federal subsidy to Fannie Mae and Freddie Mac has been estimated as high as $143 billion in 2003. Roughly half of this subsidy went to the shareholders and executives of these two corporations, yet this subsidy reduced home mortgage rates in the US by only basis points (7/100 of 1 percent).[39]

To reduce these benefits to their shareholders and executives, some have proposed that Fannie Mae and Freddie Mac be turned into public utilities with rates of return set by a regulator. The history of rate regulation in industries like airlines and electric power, however, is not encouraging. Regulators found it very difficult to calculate reasonable rates of return, and utilities managed to engage in risky activities outside the regulated envelope. Due to these drawbacks, the public utility format is usually reserved for industries characterized as natural monopolies. The mortgage market, with its many players and diverse products, does not appear to be a natural monopoly.

4. Stabilizing the Mortgage Market in Tumultuous Times

The last argument for continuing Fannie Mac and Freddie Mac is that they stabilize the trading market for mortgages in times of financial turmoil. When the secondary market becomes illiquid, these two institutions continue to purchase mortgages or MBS for their own portfolios.

However, these purchases for their portfolios entail much more risk than securitizing and selling mortgages. If these two corporations buy mortgages and MBS during a period of falling home prices, they are likely to incur large losses from credit defaults – as they did in 2008 and 2009. If they issue fixed-rate bonds to finance purchases of mortgages or MBS, and then rates decline significantly, they will suffer substantial losses as home owners refinance at lower rates.

If the top officers of Fannie Mae and Freddie Mac manage these risks well, their shareholders will reap large projects. On the other hand, if they do not manage these risks effectively, the two

institutions can easily become insolvent, as they did in 2008. Their insolvency imposes large costs not only on their own shareholders but also on all US taxpayers who are forced to pay for the bailout of these institutions.

A better approach would be to ask the Federal Reserve to perform the function of stabilizing the secondary market for MBS – in those extraordinary circumstances where such stabilization is necessary. The Fed is in the best position to evaluate the need for government intervention in any or all of the trading markets for debt securities. To promote stability in those markets, the Fed in 2009 made large purchases of MBS and other asset-backed securities. All taxpayers bear the risk of losses from those purchases by the Federal Reserve, but they also will reap the profits if those purchases turn out well.

Given the current importance of Fannie Mae and Freddie Mac to the US housing market, Congress should not abruptly stop these institutions from buying home mortgages and securitizing them. Instead, Congress should gradually lower the maximum for their mortgage purchases from $729,000 to $650,000 – and $50,000 per year thereafter – until we reach the maximum size (e.g., $350,000) for mortgages eligible for the federal insurance programs and securitization by Ginnie Mae.

Unfortunately, in passing the continuing budget resolution for fiscal year 2010-2011, Congress prevented the maximum mortgage purchased by Fannie Mae and Freddie Mac from dropping to $650,000 from $729,000, as the maximum was scheduled to do in 2011.[40] These two corporations have already cost the US taxpayers $145 billion, which could easily rise to $500 million or $1 trillion according to various analysts.[41] We need to start weaning the mortgage market off its addiction to mortgage securitization by these two corporations, as we adopt reforms to revive the private market for securitization.

III. Reviving Private Mortgage Securitization

If we want to reduce the amount of governmental support for home ownership, we need to revive the private market for mortgage originators. The total amount of US bank loans of all types was $7.4 trillion in 2010[42], only two thirds of total US housing credit outstanding at that time. The volume of new mortgages originated depends primarily on the pace of mortgage securitization. For example, a bank can originate a mortgage for $500,000, sell it to investors as part of the securitization process, and then use the sales proceeds to make another $500,000 mortgage. If this cycle happens once a month, a bank can originate many times the volume of home mortgages it could without securitization.

Moreover, mortgage securitization provides the benefits of diversification to both lenders and investors. Without securitization, lenders hold local mortgages for years and thereby are exposed to a potential economic downturn in that region. By selling local mortgages for cash, or swapping them for MBS, lenders can build a diversified portfolio of mortgages from around the country. Similarly, by buying MBS, investors can attain a more geographically diversified portfolio than buying whole mortgages from local banks. In addition, investors can easily buy and sell MBS, as opposed to home mortgages that do not have well developed trading markets.

However, the private market for mortgage securitization has contracted sharply – from a peak of $60 billion per month in 2006 to a trickle today. Without securitization, the mortgage volume of banks is limited to the maximum amount supportable by their regulatory capital. And there are many competing demands on the regulatory capital of banks. Without securitization, many non-bank lenders do not have enough capital to make home mortgages and hold them for 10 to 15 years. And mortgage lenders not owned by banks, such as independent mortgage banks and real estate brokers, normally originate a substantial portion of all home mortgages in the US.

The private market for mortgage securitization has virtually disappeared in the US because it was subject to so many abuses in 2004 to 2008.[43] As a result, investors no longer have confidence in MBS – unless guaranteed by the federal government. Thus, to revive the private market for mortgage securitization, we need to institute reforms that will prevent these abuses from occurring again.

In Part III, we review the major types of prior abuses in the private market for mortgage securitization and propose specific reforms for each type of abuse. We begin with the private sponsors of MBS, then the special purpose entities issuing MBS, and end with the credit rating agencies. We discuss the risk retention issues for mortgage securitization in Part IV.

A. Private Sponsors of Mortgage Securitization

While there are many forms of private mortgage securitization, they all involve a sponsor – typically some type of bank – creating a special purpose vehicle (SPE) to purchase a pool of mortgages from multiple originators. The sponsor establishes the SPE as a legal entity, arranges temporary financing for it to acquire the pool of mortgages, designs the various tranches of securities issued by the pool, selects a credit rating agency to rate the various tranches and helps sell these securities to public investors. In addition, the sponsor may enhance the attractiveness of these securities by providing credit support to the pool if a specified amount of its mortgages defaulted; and/or agreeing to buy back these securities from holders if the trading market for these criteria became sufficiently illiquid.

Until quite recently, the sponsor of SPEs were able to keep them off its balance sheet by exploiting certain loopholes in the accounting rules. As a result, the sponsor of a SPE was usually able to avoid allocating capital under banking rules to support the SPE and minimize disclosures about the

sponsor's obligations to the pool. Under the new rules, as explained below, SPEs will almost always remain on the balance sheet of their sponsoring bank. Furthermore, these bank sponsors will be required to allocate capital to support the mortgages in the pool – even if investors in its securities have assumed significant risks of loss from the mortgages in the pool.

In other words, the accounting and capital treatment of SPEs have gone from one extreme to another. We will outline the abuses of the prior off-balance sheet arrangement and then suggest a more functional approach to the current on-balance sheet system.

1. Accounting Issues[44]

A SPE is a legitimate method for any company to finance the purchase of assets. The SPE should not be put on the balance sheet of the company if most of the risks related to the assets and liabilities in the SPE are assumed by other investors in the SPE. However, this device can easily be abused, so the Financial Accounting Standards Board (FASB) has established rules for when a SPE may be kept off the balance sheet of the sponsoring bank or other type of company. In the late 1990s, FASB allowed a SPE to be kept off the balance sheet of the sponsor only if at least 3 percent of the voting equity of the SPE were held by a party not affiliated with its sponsor. When Enron set up SPEs in the late 1990s, it violated that FASB requirement.

After the failure of Enron, FASB in 2003 adopted new rules on when most types of SPEs could be kept off the balance sheet of their sponsor. Unfortunately, it took Wall Street only a few months to figure out how to avoid constraint in the FASB's new rules. As a result, the assets and liabilities of most SPEs did not appear on the balance sheet of anyone of the banks sponsoring these SPEs, and there were little public disclosures about their potential obligations.

In response to the circumvention of its 2003 rules, FASB adopted rules in 2009 that effectively force all SPEs financing mortgages on to the balance sheets of their sponsoring banks. As a result, bank sponsor will have to make public disclosures about the mortgages held by the SPEs. For example, banks will have to disclose their potential obligations to support a SPE experiencing a specified level of mortgage defaults.

In particular, the SEC has proposed rules that would require any sponsor of SPEs to disclose fulfilled and unfilled repurchase requests in all relevant deals over the last three years.[45] These disclosure requirements would apply both in the original offering document and annual reports. They are designed to inform investors about the actual experience of SPE sponsors in supplying ongoing liquidity for short-term securities issued by their SPEs.

2. Capital Requirements

While putting SPEs on balance sheet significantly improves disclosures by their bank sponsors, it also increases the capital requirements for these banks. Subject to a 6-month delay, the federal banking agencies at the end of 2009 adopted rules confirming that assets in bank-sponsored SPEs are fully subject to regulatory capital requirements, and eliminated the prior exclusion from these requirements for asset-backed commercial (ABC) paper programs that were consolidated on the bank's balance sheet.[46]

However, these capital requirements for bank sponsors of SPEs are inconsistent with the actual allocation of risks between the bank and investors in the SPE's securities. There are three main types of

risks involved with private mortgage securitization deals: interest rate, credit default and liquidity risks. In general, the investors in securities issued by SPEs fully assume the risk of fluctuating interest rates.

The allocation of credit default risk is more complex: the sponsor usually retains a significant portion, but not all, of the SPE's credit risk. In some deals, the sponsor agrees to substitute good mortgages for all non-performing mortgages above a specified threshold. In other deals, the sponsor creates a cushion against credit defaults by initially capitalizing the SPE with mortgages worth more than 100% of the total value of its securities, or by holding subordinated tranches of the deal to absorb the first losses on these mortgages.

Similarly, the allocation of liquidity risk varies a lot from deal to deal. When selling short-term securities in some SPEs, the sponsor represents that it will buy back all such securities if an auction for such securities fails. In other MBS deals, the sponsor does not provide the buyers of the SPE's securities with any assurances about repurchases in illiquid markets, though the sponsor can be sued by the buyers if there were material breaches of representations and warranties in connection with these deals.

In sum, the actual retention of risks by a bank sponsor can range from roughly 20% to 80% of all the risks involved in the SPE's underlying mortgages. If the regulators nevertheless force a bank sponsoring several SPEs to support their assets with enough capital to cover 100% of the risks involved, the bank will stop sponsoring SPEs. A bank cannot afford to over allocate capital and lower its returns on mortgage securitizations.

Instead, the federal regulators should encourage bank sponsors to disclose in detail their potential obligations to any SPE or its investors, along the lines of the SEC proposals mentioned above. Then the regulators could impose a partial capital charge on the bank for these obligations, based on an actual allocation of risks, which should be updated periodically in light of the experience of the SPEs sponsored by the bank.

B. Disclosure and Design of SPEs

Moving SPEs on to the balance sheet of bank sponsors will improve the disclosure of the bank's potential obligations to these SPEs. In addition, the SEC is moving to enhance the information available about the mortgages held by the SPEs. This second step will be important to renewing investor confidence in mortgage securities. A broad survey of MBS investors concluded that the highest priorities were enhanced disclosures about the individual loans in the underlying pool rather than its aggregate characteristics, in a standardized format to the maximum extent feasible.[47]

In response, the SEC has proposed detailed disclosure requirements for each loan or other asset in the pool.[48] Such data would have to be provided in a machine readable, standardized format so that it would be useful to investors. Furthermore, the SEC proposals would require every SPE to provide investors with a computer program that gives effect to the cash flow provisions of the "waterfall" structure in most deals.

In the past, an SEC rule allowed a SPE to stop filing quarterly and annual reports within a year after the initial public offering. This rule was used by SPE sponsors to limit the ongoing information flow about the status of mortgages or other assets in the pool. Under the SEC's recent proposals, the SPE would be required to file quarterly and annual reports as long as non-affiliated investors held any securities sold initially by the SPE in an SEC registered offerings. The SEC also proposes to narrow the exemptions from registration available to SPEs selling securities backed by asset pools.

At the same time, participants in the private market have begun to simplify the structure of asset-backed issuances of securities. Before the financial crisis, the structure of SPEs was inordinately complex. SPEs often issued many tranches of MBS based on the same pool of mortgages. Moreover, some SPEs issued securities based on MBS, rather than a pool of mortgages, in arrangements known as CDOs; other SPEs issued securities based on pools of CDOs in arrangements known as CDO^2.

Ultimately, the value of such multi-layered products depended on the actual payment record of the mortgage pools at the bottom of the pyramid. In such multi-layered products, a small mistake in estimating the default probability of the bottom pool of mortgages has a huge impact on the risk profile of the top tier. For example, an increase from 5% to 7% in the default rate on the mortgage pool at the bottom of a CDO^2 deal could increase the default rate in the top tier by more than 100 times.[49]

In recent months, by contrast, underwriters have started to develop simpler deals with high-quality "jumbo" mortgages – too big to be eligible for government-backed programs. In April 2010, for instance, Redwood Trust issued $238 million in MBS with senior tranches priced to yield 4%, supported by junior securities paying 6.5%.[50] BlackRock is trying to revamp the US mortgage market with a new fund that buys loans with high down payments and borrowers with good track records of repayment. To reduce potential conflicts of interest, BlackRock is hiring a loan servicer independent of the lenders participating in the program.[51]

This example represents the future of mortgage securitization – a small number of tranches of securities, based directly on a pool of high-quality mortgages, serviced by a truly independent third party. This new model for private MBS deals will be reinforced by two recent SEC proposals. In any asset-backed securities deal, the issuer will be required to disclose the nature of its review of the assets as well as findings and conclusions of such review.[52] In addition, the credit rating agency will be required to describe the representations and warranties made by the sponsors of the deal or originators of the assets in the pool, as well as the enforcement mechanisms available to investors in the pool.[53]

C. Credit Rating Agencies

Within the context of this new model for private MBS deals, what will the role (if any) be for credit rating agencies? A few MBS deals have been sold without credit ratings in private offerings to institutional investors. But many investors will still be looking to rely on an outside expert to assess the quality of the various tranches in private MBS deals. Thus, it will be difficult to revive the private market for MBS unless and until credit ratings again have credibility with investors.

Investors no longer have confidence in credit ratings because so many AAA tranches of MBS and other asset backed deals went into default during the financial crisis. The dismal record of credit ratings was due to several factors: the complexity of the deals, the short historical record for certain types of mortgages and, most importantly, the conflicts of interest built into the issuer-pays model. Since the issuer selects and pays the credit rating agency, the issuer has an incentive to shop for the agency most likely to give the highest rating to the most tranches of a MBS deal. In response, regulators and commentators have offered four main types of regulatory proposals to reform credit rating agencies. As discussed below, most of these proposals would be ineffective or unworkable.

The first set of proposals is based on the premise that the core problem is the oligopolistic structure of the ratings industry – its domination by three large firms. To promote competition in the ratings industry, Congress in 2006 directed the SEC to increase the number of ratings agencies whose ratings were approved for use in SEC filings.[54] As a result, the number of approved agencies quickly rose to 9. However, since the issuer pays model is still prevalent, this increase merely expanded the chances

for ratings shopping by issuer. If one rating agency would not give a AAA ratings to most tranches in a MBS deal, the issuer could now shop around for higher ratings with nine agencies instead of just two.

Other efforts to promote direct competition among rating agencies have also failed, and in the process, have reduced the information available to the agency hired by the issuer. The SEC now requires any issuer to disseminate to other credit agencies all the information provided by the issuer to the agency hired by the agency.[55] This dissemination requirement was supposed to encourage other agencies to promulgate ratings on deals for which they have not been hired. In fact, the potential for dissemination reduces the willingness of the issuer to provide detailed information to the hired agency. Without a clear source of payment, however, other agencies have little incentive to do the work necessary to promulgate a rating.

Similarly, to promote competition, the Dodd-Frank Act directed the SEC to remove the existing exemption for credit ratings from Regulation FD.[56] To prevent selective disclosure, that Regulation generally forces issuers to publish a press release with any material information it provides to any one party. In the past, Regulation FD contained an exemption to encourage issuers to supply confidential data to credit rating agencies in order to improve the quality of their ratings. By removing this exemption, Congress did not persuade issuers to share more information with the investing public; instead, they simply stopped giving confidential data to any rating agency.

The Dodd Frank Act includes a second approach to credit rating reform. It directs the SEC and other federal authorities to remove requirements in their rules based upon a high rating by an agency approved by such authorities.[57] While some references to ratings have been removed by the federal authorities, they have encountered considerable opposition in other areas. For instance, the investment management industry has vigorously opposed the SEC's proposed deletion of the high ratings requirement for commercial paper held by money market funds.[58] In their view, money fund managers should be legally limited to highly rated commercial paper and then do their own homework to conclude that the paper is high quality. Similarly, the banking industry has opposed the proposed deletion of references to credit ratings from the bank capital requirements.[59] In their view, these ratings represent a useful starting point for risk analysis, though not necessarily the ultimate determinant.

In any event, the laws of most states allow local pension plans and insurance companies to buy only bonds with investment-grade ratings. These state laws would not be easy to change since they provide useful guidance to small pension plans and insurance companies without the resources to evaluate a broad range of bonds. Similarly, for all their shortcomings, credit ratings provide individual investors with useful guidance on choosing bonds – especially state or city tax-exempt bonds.

Since it is not feasible to do away with all required credit ratings, commentators have suggested a third approach: moving to an investor-pays model currently used by Egon Jones. Under this model, investors would choose the rating agency for major MBS offerings and pay for the agency's services. As a result, so the argument goes, the agency would seek the most accurate rather than the highest rating.

However, this proposal does not appear to be workable. The largest investors in bonds are mutual funds, hedge funds and corporate pension plans. Since many of them do their own in-depth analysis of bonds, they object to paying for credit ratings. Yet it would be politically unacceptable for ratings to be paid for only by small investors, and not by large investors. Even if institutional investors were willing to select and pay for credit ratings, this would not be a good idea for other investors. Institutional investors have a strong interest in inaccurate ratings. When the rating of a bond is too high or low, then institutional investors can profit by selling or buying the bond.

A final group of proposals involved the selection of a credit rating agency by a governmental process designed to represent all investors. One suggestion would be to establish a credit rating agency as a public utility, with rates and methods approved by a governmental body. This proposal would, of course, eliminate any potential benefits from competition – such as lower prices or more expertise on certain types of deals. Moreover, a public utility structure would subject the credit rating agency to political pressures on ratings for governmental bonds.

Another suggestion, advocated by Senator Al Franken, would randomly allocate credit ratings among a pool of credit ratings agencies, subject to a standardized fee schedule. The pool would include any agency meeting standards set by the SEC, which would run the allocation process. Franken's proposal is now under study by the SEC.[60] However, random allocation would undermine the incentive of any rating agency to develop expertise in evaluating specific types of complex offerings. For investors in complex offerings, the rating by a randomly selected and little known agency may not be credible.

A better approach would be for the SEC to establish a group of independent consultants, such as retired executives, who would select the rating agency for each major bond offering. After circulating a RFP, the consultant would choose the credit rating agency best qualified to determine an accurate rating for the offering. The SEC would pay the independent consultant a modest fee for each offering. The bond issuer would negotiate a fee with the credit rating agency, chosen by the independent consultant, on the basis of the size and complexity of the offering.

Under this approach, the credit rating agency would be chosen by a neutral third party representing the interests of all investors. And the choice would be based on the relative expertise of that agency to provide the most accurate rating. Thus, the proposed system would avoid the potential conflicts involved when the agency is chosen by the issuer or one set of investors. Yet it would promote competition among credit rating agencies, which would have an incentive to develop expertise in specific types of bond offerings. Furthermore, the proposed system would not require any governmental authority to set fees for credit ratings.

Part IV: Toward A Middle Tier

In Parts II and III of this paper, we have suggested what the parameters should be for the government and private tiers of mortgage securitization. In this Part IV, we will review the proposals for a middle tier of mortgage securitization, below the government tier and above the normal private tier. These proposals are aimed at creating a middle tier with higher quality MBS than most private deals, but without a government guarantee or subsidy.

Part IV will begin by analyzing the proposal for "covered" bonds, backed by both a mortgage pool on a bank's balance sheet and the financial resources of the bank itself. It will argue that covered bonds will not, and should not, constitute a significant portion of MBS in the US. By contrast, it will predict tremendous growth for a new middle tier of "qualified residential mortgages" (QRMs), as defined under Section 941 of the Dodd-Frank Act. Therefore, we believe it is very important for the regulators to apply strict criteria in defining QRMs.

A. Covered Bonds

A covered bond is a debt instrument secured by a perfected interest in a specific pool of collateral – usually comprised of high-quality mortgages and other assets – which is held in a separate account on the balance sheet of a bank. In the event of a problem with the pool, the bondholder first has recourse to the assets in the pool. Moreover, if those assets are insufficient to satisfy the bondholder's claims, he or she has another claim on the bank for the difference. Hence covered bonds are said to be "dual recourse".

In most covered bonds, the underlying pool of assets is dynamic, not static. The bank sponsor must regularly monitor the assets in the pool. If any asset becomes non-performing, the bank must replace it with a performing asset in compliance with the eligibility criteria for the pool. For example, if the pool holds a mortgage that defaults, the bank must replace that mortgage with one meeting the loan-to-value ratio for the pool. In addition, the separate pool of assets underlying a covered bond is typically over-collateralized: holding more assets than the value of the covered bonds issued by the pool. Over-collateralization provides a cushion to investors in the covered bonds if most of the assets in the pool prepay or the pool suffers a large number of defaults.

The market for covered bonds is centered in Europe. At the end of 2009, there were €529 billion in covered bonds outstanding, of which over 80% were based on high-quality mortgages.[61] Covered bonds have been sold by banks recently in other countries such as Canada, Australia and New Zealand. In most countries, the terms and conditions of covered bonds are governed by a specific national statute.

In the US, by contrast, covered bonds were sold by only two banks – Washington Mutual in 2006 and Bank of America in 2007. After 2007, no covered bonds have been sold in the US, which has no specific legislation on this subject. In 2009, Representative Scott Garrett (R-NJ) introduced legislation authorizing the sale of covered bonds by FDIC-insured banks.[62] However, that legislation was opposed by the FDIC, which in 2008 issued a restrictive policy statement on covered bonds.[63]

1. Benefits of Covered Bonds

Covered bonds offer several potential benefits for banks. First, they help diversify the sources of bank funding. Covered bonds tend to have larger maturities than other financing options such as advances from Federal Home Loan Banks. In addition, covered bonds reportedly appeal to a different

type of investor than most bond offerings. These are conservative institutions that are attracted to the high-quality collateral and double recourse of covered bonds.[64]

Second, covered bonds reduce the moral hazards and agency costs inherent in the "originate-to-distribute" model. Since the collateral of covered bonds remains on the balance sheets of the bank sponsor, it has a strong incentive to demand reliable documentation and ensure that borrowers have the ability to repay. Moreover, since the bank sponsor must replace defaulting mortgages supporting covered bonds, it will likely insist on substantial down payments for these mortgages. As discussed above, negative home equity is the best predictor of defaults on home mortgages.

Finally, it is easier to modify mortgages supporting covered bonds than mortgages securitized through other legal vehicles. Because covered bonds expressly allow the bank sponsor to replace troubled mortgages in the pool, these can be removed and modified without the consent of bondholders. By contrast, most securitizations must comply with the complex rules for Real Estate Mortgage Investment Conduit (REMICs), which are based on a passive model. If a substantial portion of a REMIC's assets are "significantly modified", it may be subject to a penalty tax for active management.

2. Limitations of Covered Bonds

Despite these potential benefits, covered bonds would not be a significant driver of mortgage volume in the US. Since covered bonds remain on the balance sheet of the sponsoring banks, they are limited by the size of its balance sheet and the amount of its regulatory capital. In contrast to other forms of mortgage securitization, covered bonds do not allow a bank to sell its mortgages each month and use the proceeds to make new mortgages.

The sale of covered bonds is further constrained by the FDIC, which limits them to 4% of an insured bank's total liabilities. The FDIC explained its rationale for this limit: "The larger the balance of secured liabilities on the balance sheet, the smaller the value of assets that are available to satisfy depositors and general creditors, and consequently the greater the potential loss to the Deposit Insurance Fund."[65] In other words, the claims of covered bondholders to the assets in the separate account at the bank sponsor, including any over-collateralization, are probably senior to the claims of the FDIC if the bank becomes insolvent.

In my view, the FDIC's concerns about covered bonds are well-founded. If a large portion of a bank's assets backed its covered bonds, its best assets would go to holders of these bonds in the event of the bank's insolvency. As a result, a substantial portion of the insolvent bank would have to be absorbed by the federal government. Moreover, the holders of covered bonds usually have a specific right to more than the mortgages in the pool supporting the bonds – because of the bank's obligation to replace any defaulting mortgages in the pool with other performing mortgages from the bank's portfolio. In European parlance, the holders of covered bonds would have a "floating charge" on all the performing mortgages owned by the bank if it becomes insolvent.

In theory, Congress could limit the rights of covered bond holders to the mortgages actually held in the pool supporting those bonds at the time the sponsoring bank became insolvent. In practice, such legislation would severely undermine the attraction of covered bonds to conservative investors, who are looking for the broadest backing for their bonds. In fact, legislation in European countries has expressly enshrined the rights of covered bond holders over everyone else, despite the general trend to insist that a bank's bondholders incur some losses if it fails. In Germany, for example, if a bank fails, its losses must be absorbed partly by its bondholders – except for the holders of covered bonds who will be made whole.[66]

Covered bonds not only shift losses from large bondholders to taxpayers, but also promote a virulent form of moral hazard if holders of covered bonds do not suffer any losses when the sponsoring bank fails. Without a significant chance of a loss, holders of covered bonds will have no incentive to monitor the bank's financial condition or pressure bank management to avoid excessive risks. Without such market discipline, these difficult tasks will be left primarily to bank examiners.

B. Qualified Residential Mortgages (QRMs)

While covered bonds are not likely to become a third tier in the mortgage securitization market, QRMs will almost surely become a separate tier in this market – higher quality than the rest of the private segment but without a governmental guarantee or subsidy. QRMs are the product of a legislative compromise in the Dodd Frank Act: it generally imposes a risk retention requirement on originators and securitizers in MBS deals, yet then directs federal regulators to exempt QRMs from this requirement.

In enacting the risk retention requirement, Congress was responding to widespread concerns about the "originate-to-distribute" model, which led to so many problems during the financial crisis. Since originators planned to quickly sell their mortgages to the secondary market, they did not have enough incentive to gather the proper documents and do the due diligence on the borrower's ability to repay. Similarly, if banks sponsoring MBS deals sold all tranches to the investing public, they did not have sufficient incentive to make sure that these deals were designed to withstand downturns in home prices and that all the risks in these deals were fully disclosed to investors.

To realign these incentives, Congress wanted mortgage originators and securitizes to have "skin in the game" – to retain an economic interest in the mortgages and MBS they sold. In specific, Section 951 (c) of the Dodd Frank Act directs the federal banking agencies to adopt joint regulations requiring any "securitizer" to retain an economic interest "not less than 5 percent of the credit risk" of an asset-backed security. In an apparent drafting ambiguity, Section 951 (d) of the Act also directs these agencies "to allocate risk retention obligations between a securitizer and originator" according to criteria specified in the statute.

Nevertheless, Congress was worried that a strict application of a risk retention requirement would dramatically decrease the volume of mortgage originations and securitization. After originating and selling mortgages, for example, small brokers might not be able to hold capital reserves against potential losses. Therefore, Congress gave the federal banking agencies broad discretion to define QRMs that would be exempt from the risk retention requirement. As directed by Congress, these agencies have published a study on this requirement – which concludes that it should be customized to each type of asset-backed securities deal.[67] By April of 2011, these agencies must promulgate detailed rules defining the QRMs exempted from the risk retention requirement.

1. Narrow Definition of QRMs

The Dodd-Frank Act includes a long list of factors to be considered by the federal banking agencies in defining QRMs. These factors generally involve product features and underwriting standards that have been historically associated with relatively low levels of mortgage defaults. But QRMs will not encompass any mortgage directly or indirectly guaranteed or insured by the federal government; such mortgages are categorically excluded from the risk retention requirement.

Thus, the regulators face a dilemma. On the one hand, if they define QRMs narrowly, they are likely to reduce the volume of home mortgages in the private sector due to the expansive application of

the risk retention requirement. On the other hand, if they adopt a broad definition of QRMs, they will likely increase the level of defaults for such mortgages since they will not be backed by the federal government and they will not be subject to any risk retention requirement.

In my view, the federal regulators should opt for a narrow definition of QRMs. Risk retention is a critical protection for investors in home mortgages; it aligns their interests with those of originators and securitizers. If both groups will have no "skin in the game" for QRMs, this exemption should be defined quite narrowly to include high down payment requirements – even though the statutory factors for QRMs do not include the loan-to-value ratio of a mortgage.[68]

Moreover, the definition of QRMS should be narrow because it impacts other significant rules governing the securitization of private mortgages. Most importantly, before the passage of the Dodd-Frank Act, the FDIC proposed a safe harbor – agreeing not to reclaim mortgages previously transferred to an SPE by an insolvent bank under specified conditions. One proposed condition was that the bank sponsoring the SPE retain at least 5% of the credit risk of the securities issued by the SPE.[69] Shortly after the passage of the Dodd-Frank Act, the FDIC adopted this proposal as a permanent safe harbor with a major caveat: once the federal agencies define QRMs, a securitization based only on QRMs would no longer have to comply with the risk retention requirement in order to take advantage of this FDIC safe harbor. [70]

Similarly, before the passage of the Dodd-Frank Act, the SEC proposed significant revisions to its existing rules for "shelf registrations" of asset-backed securities – which allow the public offering of such securities on a continuous or delayed basis without SEC review of the offering documents for each transaction. Under existing SEC rules, shelf registration is available to asset-backed securities only if they are rated investment-grade. On May 3, 2010, the SEC proposed to replace this ratings condition for shelf registration with four new criteria. One of those criteria is that the sponsor of the asset-backed securities offerings retain a 5% economic interest in the securities.[71] However, this criteria would likely be dropped for securities backed solely by QRMs once they are defined by the federal banking agencies.

In sum, mortgage securities based on QRMs could be offered quickly through shelf registrations, without any risk retention requirements for originators or securitizers. If the bank sponsoring such mortgage securities later became insolvent, the FDIC would not seek to attach the mortgages underlying these securities. Because of these regulatory advantages, QRMs have the potential to crowd out all other mortgages in the private sector.

2. QRMs for Fannie and Freddie

Although the risk retention requirement does not apply to mortgages insured or guaranteed by federal agencies, it does apply to conforming mortgages purchased by Fannie Mae or Freddie Mac; they are not considered federal agencies for this purpose. As a result, executives at these two corporations are pushing for QRMs to include all conforming mortgages sold to them. According to these executives, such conforming mortgages represent the high end of the private mortgage market -- which Congress meant to exempt from the risk retention requirement. In my view, however, QRMs should not permanently include all such conforming mortgages; rather, the definition of QRMs should be narrowed over time to help phase out the role of Fannie Mae and Freddie Mac, as suggested in Part II of this paper.

A QRM designation for all conforming mortgages sold to Fannie Mae and Freddie Mac would not only exempt their originators from the risk retention requirement of the Dodd-Frank Act, but also would offer these originators a highly liquid market for disposing of their mortgages. In practice, the

combination would reinforce the originate to distribute model that proved so disastrous during the financial crisis. If conforming mortgages sold to these two corporations were categorically considered QRMs, then almost all privately issued mortgages would be structured to fit within this category. Why would any broker or bank establish a reserve for potential losses and take the bankruptcy risk involved with private securitization of its mortgages, instead of just selling all of its mortgages to Fannie Mae and Freddie Mac?

As discussed in Part II, the current domination of the private market for mortgage securitization by these two corporations, even if needed temporarily, involves significant long-term costs. The US Treasury has already infused $145 billion to cover losses at Fannie Mae and Freddie Mac, and should be reluctant to increase the price tag of the federal bailout. Moreover, in the future, if we want to focus government subsidies for home ownership on helping needy families, it is critical that the role of these two corporations be reduced and replaced with private securitization vehicles for middle and high income families. Yet a permanent QRM designation for conforming mortgages bought by Fannie Mae and Freddie Mac would expand their role.

To address these long-term concerns while recognizing the current fragility of the US housing market, the federal regulators should develop a multi-stage definition of QRMs as applied to conforming mortgages sold to Fannie Mae and Freddie Mac. In specific, the definition should cover such conforming mortgages in size up to $650,000 for 2012, $600,000 for 2013 and so forth until the size limit falls to $350,000. At that time, as discussed in Part II, Fannie Mae and Freddie Mac should be replaced by Ginnie Mae as the securitizer of newly originated mortgages with federal subsidies primarily based on family income. In that manner, the definition of QRM would facilitate the gradual phasing out of the role played by Fannie Mae and Freddie Mac in the private mortgage market.

3. Long-Term Mortgages and Prepayment Penalties

Similarly, the definition of QRMs should be used to promote the continuation of long-term, fixed rate mortgages in the US by taking a more realistic approach to prepayment penalties.
Americans have become accustomed to easily finding 30-year mortgages with a fixed interest rate and no prepayment penalties. But the US is an international exception for good reason -- it is almost impossible for any financial institution to manage the asymmetrical risks inherent in a 30-year, fixed-rate mortgage without any prepayment penalties.

In most countries, financial institutions offer only adjustable rate mortgages: although they often have terms of more than 20 years, their interest rate adjust on a yearly basis or more frequently. While France and Germany do offer long-term mortgages at fixed interest rates, they impose stiff penalties on early prepayment of these mortgages. Canadian presents a third approach -- long-term mortgages but rates and other terms are effectively renegotiated every five or ten years.[72]

If private lenders offer 30-years, fixed-rate mortgages with no prepayment penalties, they face an asymmetrical set of risks that practically cannot be eliminated through financial management. If interest rates rise, the payments by borrowers on these long-term mortgages will not be sufficient to cover their short-term funding costs and generate a reasonable profit. On the other hand, if interest rates fall, these same lenders will not enjoy large spreads between continued high payments on mortgages and lower interest rates on short-term funding, because many borrowers will prepay their mortgages and refinance them at the lower current rates.

The challenge of these asymmetrical risks cannot be easily resolved through financial engineering. Indeed, in 2002-2004, Fannie Mae and Freddie Mac ran into horrendous accounting problems when they tried to hedge against these risks.[73] A better approach would be for the federal regulators to allow prepayment penalties in QRMs with long terms meeting certain standards. The

conditional acceptance of prepayment penalties in QRMs would set a powerful precedent for the rest of the private market for home mortgages in the US.

In taking this approach to QRMs, the federal regulators should generally take their lead from the standards for "qualified mortgages" in other sections of the Dodd-Frank Act.[74] These sections forbid prepayment penalties in subprime and high-cost mortgages, since home buyers should be able to easily switch out of these onerous mortgages. By contrast, these sections allow prepayment penalties -- up to 3% for the initial 3 years of a mortgage -- in fixed-rate mortgages of high quality without excessive fees. But the time limit for prepayment penalties should be extended from 3 to 5 years so that lenders would have a reasonable period to avoid the dilemma of asymmetrical risks on long-term, fixed rate mortgages.

4. Other Aspects of QRMs

The risk retention requirement of the Dodd-Frank Act applies to all originators of mortgages who sell them into the secondary market and the securitizers who transform these mortgages into MBS. Thus, in defining QRMs, federal regulators should adopt criteria that would help standardize home mortgages and simplify securitization structures in the US. In addition, the criteria should require language in the governing documents of MBS that would facilitate the modification of mortgages in the securitized pools.

In countries such as Denmark, the terms and conditions of home mortgages are highly standardized. This makes it less expensive to originate mortgages and easier to package them into securities. In fact, almost every home mortgage in Denmark is securitized in the same format.[75]

Although such a high degree of standardization would be beneficial to the American mortgage market, it is probably too complex for the "one-size, fits all" approach of Denmark. Nevertheless, the federal regulators should delineate two or three standardized forms for home mortgages, which would clearly qualify as QRMs. Since QRMs will be so important to originators and securitizers of mortgages, these standardized forms will become widely accepted in the US mortgage market.

In this same vein, the federal regulators should limit the availability of the QRM exemption to relatively simple structures for mortgage securitization. For example, the risk retention requirement should apply to mortgages transformed into securities only if the securities are based on a single pool of actual mortgages (rather than on a pool of MBS or CDOs) with fewer than four tranches of securities. Such a simplified structure would be easier to evaluate by credit rating agencies, and would be more attractive to investors burned by complex structures during the financial crisis.

Several Senators and Representatives have asked the federal regulators, in defining the QRM exemption, to address the problems involving servicers of securitized pools.[76] If these servicers are affiliated with the sponsors of these pools, they cannot be relied upon by investors to resolve disputes in a fair manner. Similarly, if these servicers own subordinated tranches of MBS they are servicing, they have a serious conflict of interest. Therefore, the definition of QRM should require that the servicer of a securitized mortgage be truly independent without material conflicts of interest.

Even a truly independent servicer will be challenged by requests from borrowers to reduce the payment of principal or interest on mortgages in the pool. Servicers have often refused to consent to such mortgage modifications because they are not expressly authorized by the governing documents of the pool.[77] To provide guidance in these situations, the QRM definition should require that the governing documents of the relevant MBS pool specifically authorize an independent servicer to agree to such mortgage modifications if the servicer reasonably believes that they will likely increase the returns from those mortgages to the pool.

Conclusions

To promote home ownership, the US provides a broad range of governmental subsidies to home mortgages. Yet the link between these subsidies and home ownership is weak. Without most of these subsidies, the home ownership rate is higher in other industrialized countries with similar legal systems, such as Australia, Canada and UK.

Assuming, as this paper does, that the US will continue to support some concept of home ownership, Congress should target governmental subsidies for home mortgages to households meeting both of two criteria. The households cannot afford to buy a home without these mortgage subsidies; and, with these subsidies, they have the ability to meet the monthly payments on the home's mortgage. This combination would spread the social benefits of home ownership among more Americans, without imposing the costs of mortgage defaults on individual homeowners and their neighbors.

The current governmental subsidies for home ownership in the US are poorly designed to meet these two tests, and they are also very costly. To promote more home ownership at a lower budget expense, Congress should reduce and reshape the current governmental subsidies for home ownership and adopt various measures to revive the private market for mortgage securitization.

The tax deduction for mortgage interest is available only to taxpayers who itemize deductions, and this deduction is most valuable to the taxpayers in the highest income tax bracket. But these are precisely the households least likely to buy homes mainly because of a tax benefit. To maximize the impact of tax expenditures on the home ownership rate, Congress should transform the interest deduction into a tax credit for interest paid on mortgages. Such a tax credit would be more attractive than a tax deduction to a household with modest income on the fence about buying a home.

Alternatively, Congress should lower the maximum mortgage eligible for the interest deduction from $1 million to $500,000 per household, as recently recommended by the co-chairs of Deficit Commission. In addition, Congress should enact two other proposals made by the co-chairs of the Deficit Commission -- eliminating interest deductions for mortgages on second homes and home equity loans. Neither increases the rate of home ownership, and both are quite costly from a budget perspective.

As Congress should try to increase the rate of home ownership through the tax code, it should revise federal and state laws to minimize the rate of mortgage defaults. Most importantly, Congress should gradually raise the minimum down payment on all home mortgages insured through federal agencies like the FHA and VA -- which currently range from zero to 3.5% of the home purchase price. With such minimum down payments, the home equity of borrowers will turn negative as soon as housing prices fall. And negative equity is the key driver of mortgage defaults.

Congress should also over-ride the laws of certain states that prevent any lender from going after a borrower's personal assets when trying to collect a deficiency after a mortgage foreclosure. Such state laws encourage borrowers to buy homes with minimal down payments because they can simply walk away from a mortgage without any personal liability. If, in a specific case, a borrower does not have the ability to pay a deficiency after a mortgage foreclosure, he or she can choose to file for bankruptcy. The bankruptcy judge would then be in the best position to evaluate the borrower's ability to pay a foreclosure deficiency claim relative to his or her overall financial situation.

More generally, Congress should gradually switch federal programs for mortgage insurance away from the amount of the home's price to the annual income of the borrower. It makes no sense to provide government-subsidized mortgage insurance for a $500,000 home to a professional couple with $500,000 in annual income. A household should be eligible for government mortgage insurance if their income is below a reasonable level -- e.g., below the median income level for the metropolitan area.

To securitize home mortgages insured by the federal government, we already have a federal agency -- Ginnie Mae -- that has operated successfully for many years. If Congress decides to expand its

federal subsidies for home mortgages, it should do so directly through on-budget appropriations. Further, if Congress wants the federal government to support the securitization of other types of home mortgages, it should utilize Ginnie Mae – with accurate pricing of its guarantees that are reflected on the federal budget. Ginnie Mae is a much more efficient way to securitize home mortgages than Fannie Mae or Freddie Mac. Most of the government subsidies implicit in their special privileges went to the shareholders and executives of these two corporations, rather than homeowners.

Some have argued that Fannie Mae and Freddie Mac should survive in order to attract enough capital to meet the needs of the home mortgage market. But this argument is weak if the federal government is already subsidizing home mortgages for those households whose needs are not being met by the normal workings of the capital markets. Others have argued that Fannie Mae and Freddie Mac should survive in order to buy mortgages and MBS if those markets become illiquid. But this role is now being performed by the Federal Reserve Board, which is in a better position to evaluate the need for such buying relative to the overall liquidity of the debt markets.

The strongest argument for the survival of Fannie Mae and Freddie Mac is the recent demise of the private market for mortgage securitization in the US. Although its demise was the result of abuses before the financial crisis, its revival is now stymied in large part by the tremendous expansion of the activities of these two corporations. With two aggressive buyers and securitizers of home mortgages, controlled and financed by the US Treasury, it would be very difficult for a private player to succeed in the market for mortgage securitization. Therefore, the federal government should gradually reduce the role of these two corporations as it implements measures to correct the past abuses in the private securitization process.

Federal regulators should begin by adopting capital requirements for bank sponsors of MBS that reflect the actual allocation of risks between the bank and other parties. Before the financial crisis, banks sponsors allocated almost no capital to support their obligations to sponsored MBS pools and their investors. This was wrong. But it is also wrong to impose on a bank a capital charge for all of the assets securitized as MBS as if they were still owned 100% by the bank. This capital charge does not reflect the realities of mortgage securitization and will deter most banks from engaging in the process.

At the same time, the federal regulators should encourage simpler designs and more detailed disclosures for MBS deals. Both these objectives are already being pursued by the federal regulators; they can reinforce these objectives by putting appropriate criteria into the definition of QRMs. The criteria for QRMs will not only define the exemption for the risk retention requirement but also will be incorporated into other exemptions by the SEC and the federal banking agencies. As a result, the criteria for QRMs will establish strong precedents that are likely to pervade the whole market for conventional mortgages.

In particular, the federal regulators should use the definition of QRMs to promote the continuation of long-term, fixed-rate mortgages in the private market. The US is the only country in the world offering 30-year, fixed-rate mortgages without any prepayment penalties. However, such mortgages are not financially viable absent a governmental subsidy. If interest rates rise, the yield on these fixed-rate mortgages will likely drop below the deposit rates paid by mortgage lenders. On the other hand, if interest rates fall, borrowers will prepay quickly and refinance into mortgages with lower fixed rates. To allow lenders to protect themselves against these asymmetrical risks, the regulators should state that QRMs may charge prepayment penalties for the initial five years on home mortgages if they meet other quality standards.

Similarly, regulators should build into the QRM definition a few standardized formats for conventional home mortgages. Such standardization would reduce the costs of securitization and would increase the transparency of the process to investors as well as credit rating agencies. The standard terms and conditions of all QRMs should include a requirement that the servicer of any MBS pool be independent of the pool's sponsors and underwriters, and that the servicer be expressly authorized to

approve modifications of mortgages in the pools under certain conditions. For example, the servicer might be required to find that the mortgage modification would reasonably increase the total return of the mortgage to the pool.

In short, the US is gradually moving toward a three-tiered system for home mortgages and their securitization. The first tier, which is currently dominant, will consist of mortgages insured and securitized through government-subsidized programs. Congress will hopefully reduce the scope and cost of this first tier by tying these subsidies more effectively to the promotion of home ownership. The second tier will be the QRMs, which should become popular once they are defined by regulators in April of this year. The regulators will hopefully limit QRMs to home mortgages meeting high-quality standards, which are securitized through relatively simple and transparent structures. The third tier will be all the remaining home mortgages in the US – which will not qualify for governmental subsidies and will not meet the exemptive criteria for QRMs. This third tier will develop slowly as investors gain more confidence in the reforms being implemented on the origination and securitization of conventional mortgages.

Table I: International Comparison of Selected Indicators of Governmental Support of Home Mortgages*

Country	Percent of Households Owning Homes	Tax Deduction for Mortgage Interest	Availability of Non-Recourse Mortgages	Government Insurance for Mortgage Defaults	Government Backed Mortgage Securitization
Australia	70%	No	No	No	No
Canada	68%	No	No	Limited	Limited
England	68%	No	No	No	No
France	57%	No	No	No	No
Germany	46%	No	No	No	No
US	67%	Yes	Yes	Extensive	Extensive

*Sources – Alex Pollock and Michael Lea, Testimony at Hearing on Comparison of International Housing finance Systems, before the Subcommittee on Security and International Trade and Finance of Senate Banking, Housing and Urban Affairs Committee
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