Discussion of Hancock & Passmore:

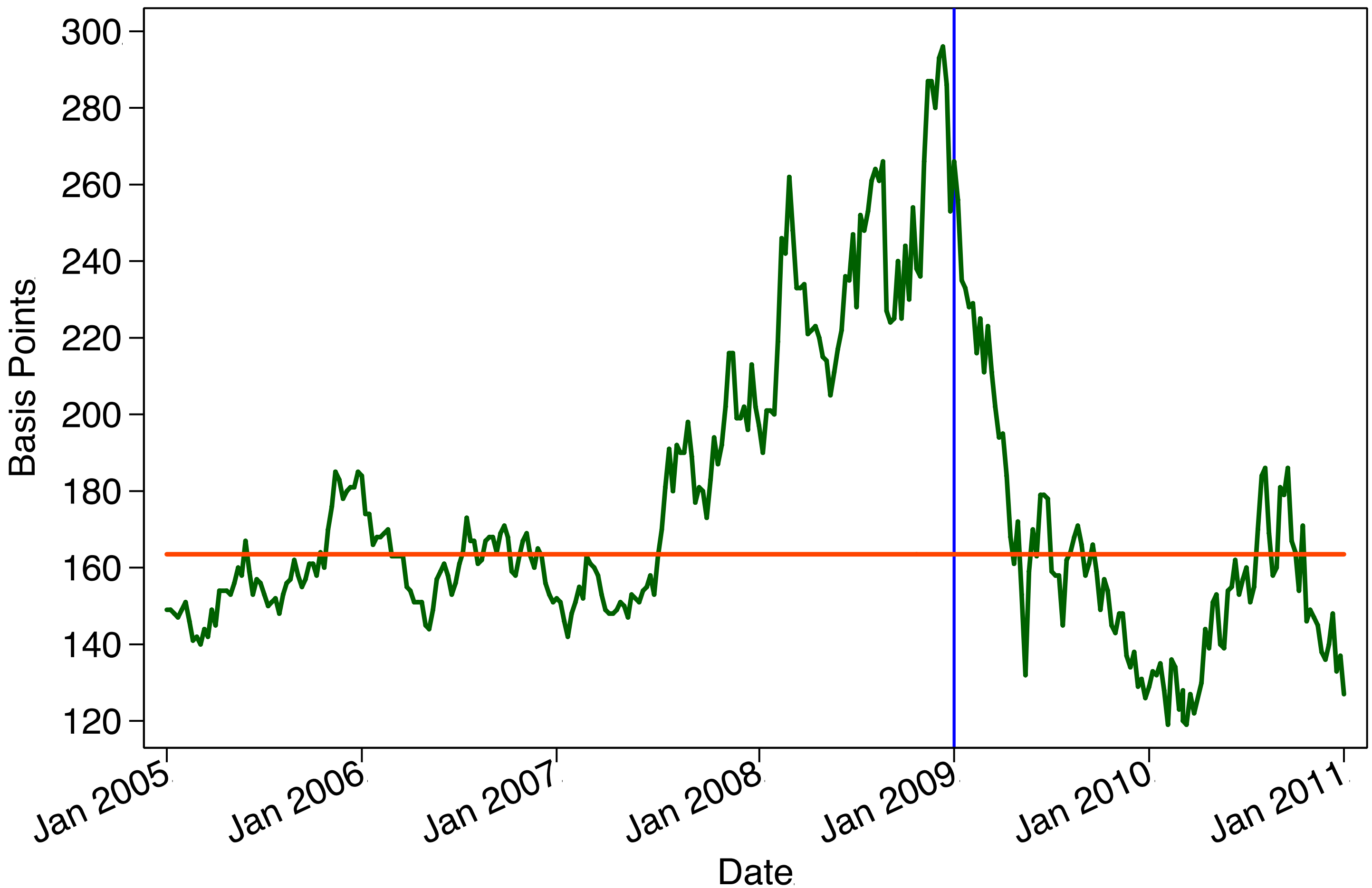
“Catastrophic Mortgage Insurance & Reforming F&F

By Professor Chris Mayer

Summary of paper

- Mortgage securitization is fragile
  - Adverse selection: Originators “cherry pick” the best mortgages
  - Costly due diligence by originators
  - Outcome: originators hold the safest and riskiest mortgages in portfolio and securitize the rest
    - Note: Is this what really happened in the crisis? (There are many more frictions than in this model)
  - Get runs due to fickle nature of some investors who demand very safe returns and the nature of credit guarantee with securitization

The spread between mortgage and 10-year rates rose 1.4% above "normal"



Source: Freddie Mac, St. Louis Federal Reserve
30−Year Fixed−Rate Mortgage Rate − 10−Year Treasury Constant Maturity Spread
Current as of January 20, 2011

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Summary of paper

- Government should provide catastrophic insurance on qualifying mortgages (LTV<60%, good credit) to ensure financial stability
- Role of Fannie & Freddie: Purchase mortgages that fit very strict underwriting criteria
- Government might also create insurance agency to provide analogous support for covered bonds or other MBS with similarly safe instruments
- Explicit pricing of guarantee in mortgage insurance premium (how is this calculated?)

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Key themes in this paper (and others)

- Liquidity is important benefit of securitization
- Government will always step in to stop inevitable runs on lenders (moral hazard)
- Mortgage guarantee should be priced appropriately
- “Too much” housing investment; get rid of subsidies
- Affordable housing mandate should be removed from new housing finance system given to FHA or other govt agencies

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Observations

- Do mortgages really deserve such special treatment relative to other assets? (YES; at least to some extent)
- Government has a key role in guiding lending process
  - Must try to prevent future foreclosure waves
  - Should mortgages have some insurance to protect homeowners against severe house price declines?
- Regulation of ABS and other elements of shadow banking are important (esp. rating process, embedded leverage, and incentives)
  - Help with liquidity
  - Prevent costly runs

Observations

- Agree with the authors that regulating mortgages is easier and more effective than regulating lenders
  - Ensures equal playing field across types of lenders
  - HARD to regulate capital and too-big-to-fail lenders
  - LTV requirement would encourage savings and reduce likelihood of default waves
  - Affordable housing could be accomplished thru matching down payments or tax-free private savings accounts

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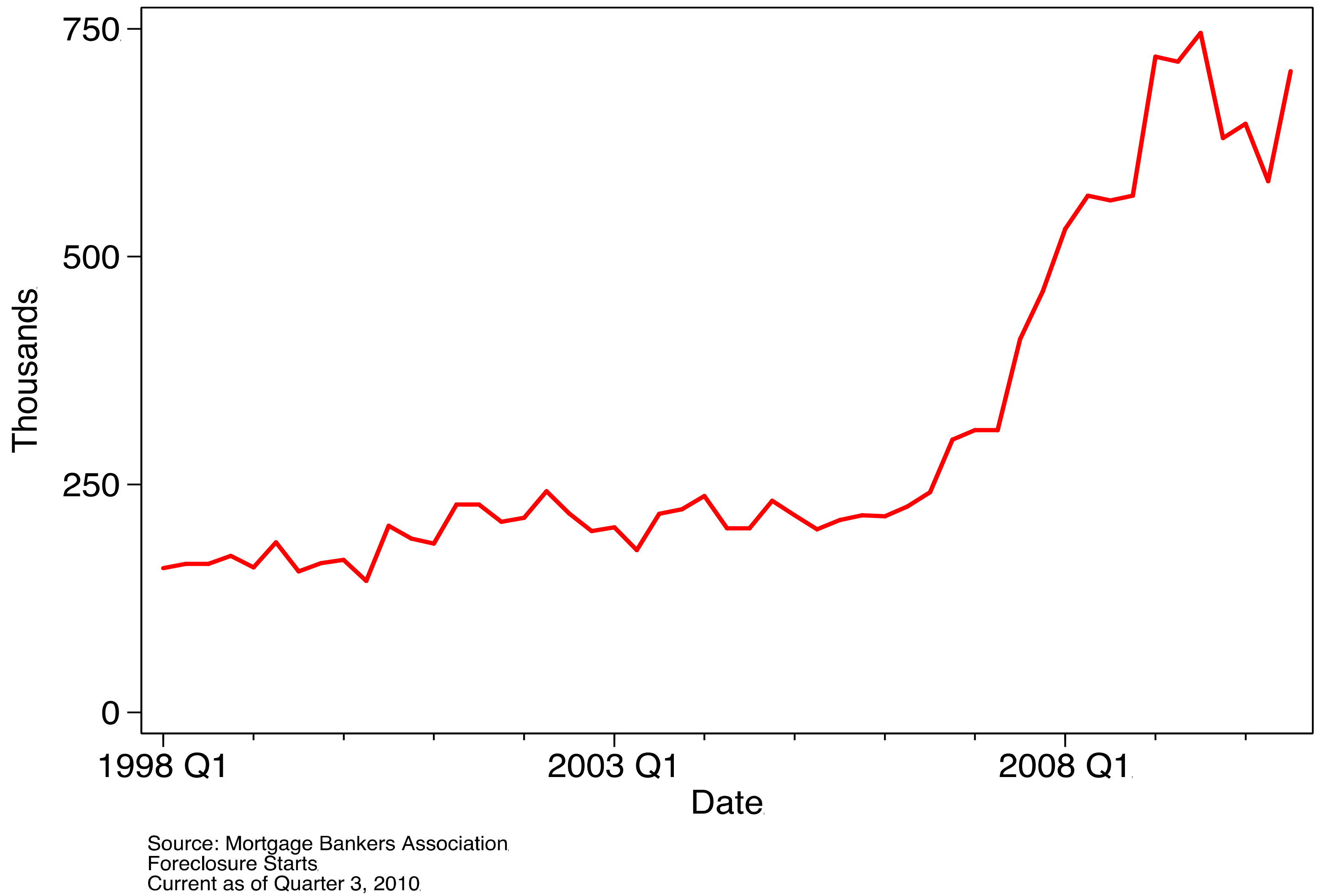
Observations

- What is special about 30-year fully prepayable FRM?
  - Evidence from crisis shows that defaults were predominantly due to poor underwriting rather than bad mortgage instruments
  - Refinancing exacerbates opportunities for less sophisticated households to make bad decisions
  - Refinancing is hugely costly!
- Alternative: mortgages with prepayment penalties
  - Used in many countries around the world
  - Enhance affordability (lower rates) for risky borrowers without government subsidies

Foreclosure starts near new highs (& 4.3 million more may be coming)!



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Observations & Conclusions

- Do not forget about what is happening today
  - Lack of private MBS today due to regulatory uncertainty and little confidence in the process
  - Need to have a new system before pulling rug out on GSEs (dangerous to reduce lending limits now)
  - Help homeowners refinance thru GSEs (Home Act or other programs)
- Covered bonds should not be lost! (natural mechanism for government intervention in crises without completely bailing out lenders)
- What about the FHA?