Comments on “Toward a 3-Tiered Market for US Home Mortgages”

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"The shapers of the American mortgage finance system hoped to achieve the security of government ownership, the integrity of local banking and the ingenuity of Wall Street. Instead they got the ingenuity of government, the security of local banking and the integrity of Wall Street."

David Frum, National Post, July 11, 2008

“..the GSEs play an extraordinarily successful double game…[telling] Congress and the news media, ‘Don’t worry, the government is *not* on the hook’ – and then turn around and tell Wall Street, ‘Don’t worry, the government really *is* on the hook.”

Richard Carnell, Senate testimony, February 10, 2004

Overview of Pozen paper

- Critical of current housing policy and subsidies
- Phase out Fannie & Freddie
- FHA should focus on lower-income, first-time buyer (lower max mortgage, etc.)
- Private market for most MBS won't need government support
- "Middle tier" of QRMs should be narrow
- Lots of other things
  - Credit rating agencies, covered bonds, prepayment penalties [fees!], etc.

U.S. housing subsidies generally

- Don’t promote home ownership
- Do encourage
  - Too much house on too much land
    - Housing stock is 30% too large; GDP is 10% too small
  - Suburban sprawl
  - Excessive household leverage
- Favor high-income households, not low-income
  - More likely to itemize
  - Bigger sum to deduct, higher marginal tax rate

An International Comparison of Home Ownership Rates

Rank	Country	Ownership rate	Rank	Country	Ownership rate
1	Singapore	89%	14	Canada	68%
2	Spain	85%	15	Sweden	68%
3	Iceland	83%	16	New Zealand	68%
4	Belgium	78%	**17**	**United States**	**67%**
5	Norway	77%	18	Japan	61%
6	Portugal	76%	19	Finland	59%
7	Luxembourg	75%	20	Czech Republic	59%
8	Ireland	75%	21	France	57%
9	Chile	73%	22	Netherlands	57%
10	Italy	72%	23	Austria	56%
11	Israel	71%	24	Denmark	54%
12	Australia	70%	25	Germany	46%
13	U.K.	68%	Source:	Pollock (2010)	

Protecting the U.S. economy against future housing problems

- The housing collapse of 2006-2009 was so devastating because highly leveraged financial institutions had too little capital to absorb losses
  - The problem wasn't about "originate to distribute" – too many large financial institutions "ate their own cooking"
    - And suffered death or "near-death" experiences
- Financial institutions must have more capital (less leverage) and be better prudentially regulated for the future

The “dot.com” bubble losses

- Between year-end 1999 and year-end 2002, the bursting of the “dot.com” bubble meant aggregate stock market losses in the U.S. of about $7 trillion
- Although no one likes $7 trillion in losses, the financial system was able to handle these losses without a great deal of disruption
- The U.S. economy experienced a mild recession and moved on

The housing bubble losses

- If national home prices fall 35% from their mid 2006 peak, the aggregate losses will be about $7 trillion
  - Most of the losses will be absorbed by households
  - Perhaps $1½ trillion of the losses will be imposed on the financial sector
- The $1½ trillion in losses have torn the U.S. financial system apart
  - And with it the U.S. economy

Why the difference?

- The losses of the burst “dot.com” bubble were mostly absorbed by household portfolios of stocks, mutual funds, and pension funds – all <u>unleveraged</u>
- The financial sector’s losses from the burst housing bubble have been in <u>highly leveraged</u> financial institutions, with inadequate capital to absorb the losses
- Some of these financial institutions are large and widely interconnected: systemic risk
  – Runs

Fifteen Largest Financial Institutions in the U.S.
(by asset size, December 31, 2007)

Rank	Financial institution	Category	Assets ($ billion)	Equity as a % of assets
1	Citigroup	Commercial bank	$2,182	5.2%
2	Bank of America	Commercial bank	1,716	8.6
3	JPMorgan Chase	Commercial bank	1,562	7.9
4	Goldman Sachs	Investment bank	1,120	3.8
5	American International Group	Insurance conglomerate	1,061	9.0
6	Morgan Stanley	Investment bank	1,045	3.0
7	Merrill Lynch	Investment Bank	1,020	3.1
8	Fannie Mae	GSE	883	5.0
9	Freddie Mac	GSE	794	3.4
10	Wachovia	Commercial bank	783	9.8
11	Lehman Brothers	Investment bank	691	3.3
12	Wells Fargo	Commercial bank	575	8.3
13	MetLife	Insurance	559	6.3
14	Prudential	Insurance	486	4.8
15	Bear Stearns	Investment Bank	395	3.0

Note: The Federal Home Loan Bank System ($1,272B) and TIAA-CREF ($420B) have been excluded from this list; if GE Capital were a standalone finance company, its asset size ($650B) would have placed it at #12.

Conclusion

- Housing policy, housing finance, and GSE issues are difficult
- But they are important!
- Stay tuned…