THE BROOKINGS INSTITUTION

RESTRUCTURING THE U.S. RESIDENTIAL MORTGAGE MARKET: NEW RESEARCH FROM HOUSING EXPERTS AND PERSPECTIVE FROM ALAN GREENSPAN

(SECRETARY GEITHNER'S REMARKS)

Washington, D.C.
Friday, February 11, 2011

P R O C E E D I N G S

MR. BAILY: I'd like to welcome everybody to Brookings. I think we have a very exciting day. And we're going to start off with a great treat, which is to welcome Treasury Secretary Tim Geithner.

Tim, of course, needs no introduction. As you know, he has been one of the key players, with Ben Bernanke, With Larry Summers, with Henry Paulson, in stemming the tide of this financial crisis and starting to turn the economy around. He also has been the architect of the financial reform proposals that became the Dodd-Frank Bill. And one of the pieces that was not included in this bill was what to do about the GSEs.

So now, today, Treasury has released a white paper describing their plans on that issue. And we're just very delighted that you chose to come here to Brookings to talk about it.

So let me ask you, first of all, if you would give us a sort of brief description of what the plan is, and how is it going to be implemented.

SECRETARY GEITHNER: Thank you, Martin. Nice to be at Brookings. And you guys have good timing for your conference today, and I'm glad you've given me a little chance to come in at the beginning.

So we, obviously, got a lot of things wrong in the housing market in the United States. And it is a complex system. And reform requires a careful strategy that includes a number of different elements. And let me just lay out the basic pillars, the basic foundations, of what we think is a credible reform plan.

The first, of course, is that we need to wind down Fannie and Freddie, and substantially reduce the government's footprint in the housing market. And that's a process that has to happen gradually, because they are now the dominant source of housing finance. And we want to be careful that that process happen in a way that doesn't interfere with or impede the process of repairing the housing market that still has a long way to go.

For the private market to take on a greater share of the burden of providing housing finance we have to have in place -- outlined and understood -- a new set of rules of the game for all the pieces of the mortgage market. And that means clarity on the capital banks have to hold against mortgage risks.

It means stronger underwriting standards so that homeowners have to hold more equity in their homes. It means better protection for consumers, comprehensive oversight of servicers and all others involved in the basic chain of housing finance. It means better incentives for securitization, clarification on risk retention. That comprehensive set of reforms that are laid out in Dodd-Frank have to be put out to the market to give investors and banks time to adjust, to understand, what will be the new economics of making mortgages in this country.

The third piece is to define a substantial but more targeted role for the government in supporting affordability -- both for people who want to own a home, and people who people who want to rent. And the paper lays out a series of basic elements of a reformed role for the government -- concentrating on the FHA -- in helping support those basic objectives.

And finally, of course, is the end game. And taking advantage of a lot of work that many of you have done, we provide a brief overview of the full spectrum of options out there for future reform. And we try to narrow the field to a more credible set of ultimate reform options. And the three we lay out in the paper -- just to summarize them briefly -- are an approach that is limited to the role the FHA provides, a proposal that would complement the FHA's role with an emergency back-stop mechanism that would only be deployed in crisis. And a third option is an FHA, alongside a redesigned and much more limited but standing guarantee or insurance mechanism that would be available for a broader class of homeowners.

Those all have very different implications for the nature of the government support, for the vulnerability of the market in future housing crises, future recessions. And we think it's helpful for the broad set of stakeholders in the country and on the Hill to spend some time trying to fully understand the implications, the relative merits, the disadvantages of those mix of options.

In laying those out, we do take the view that it would be fundamentally untenable for the country to adopt a model where the government plays no role. And we also think it would not make sense for the country for the government to be in the position, on an ongoing basis, of guaranteeing 80, 90 percent of the mortgage market, which many people have suggested.

So we start this process of legislation with a white paper, which I think is a good way to do it. There's going to be a long process of hearings on the Hill. When we get a little further in that process, then Congress should be in a position to legislate. And we will, at that point, provide our views more directly on what mix of those final options makes sense.

But, again, we're going to make sure -- we don't have a monopoly on ideas. A lot of good ideas out there, and we try to draw on those in this paper. And we'll continue to work very closely with all the stakeholders in this process so that we're taking advantage of the best ideas for reform out there.

Of course, we need to proceed carefully and gradually -- not just because this is very complicated but, as you know, we're still living with the traumatic damage, scars, caused by this recession. You see those still in housing most powerfully.

MR. BAILY: Now, in the plan, you retain an important role for the government is helping affordable housing, helping people -- either rental housing or ownership housing.

Now there are a set people -- we've got a range of interesting papers for this conference that cover the sort of spectrum -- but there is a view that the effort to provide affordable housing is really what brought down the housing market. That that was, you know, do-gooders that thought they should get everyone into a home, and we ended up, through CRA, and through these affordable housing goals, that that brought down the global market.

Could you comment on this sort of affordable housing, and the role you think it may or may not have played in the crisis?

SECRETARY GEITHNER: Well, I think it's absolutely the case that the U.S. government provided too much support for housing, too strong incentives for investment in housing. And we just took that too far.

And alongside that basic set of mistakes in the incentives we created, we allowed our financial system to take on too much leverage. We allowed a huge amount of basic mortgage business to shift where there was no regulation and oversight. We allowed the market to build up really terrible incentives around underwriting and securitization. We allowed underwriting standards to erode dramatically. And those things are -- I think they were avoidable mistakes.

And, again, it's important to recognize that this was not just about what Fannie and Freddie ultimately did to follow the market down. It as about a much more comprehensive set of failures in the basic design of oversight, and incentives in the system.

And so -- absolutely, the government did too much, and what it did, it did quite poorly. And, as you know, a lot of the basic subsidies and incentives the government provided were not really targeted to people who were at the lower side of income across the United States.

So our general view is, there's a very important role for the government, not just in providing access to affordable housing, but in getting the incentives better, oversight better, constraints on risk-taking better, underwriting standards more conservative -- and that's the critical part of this reform plan.

MR. BAILY: Now, sort of in the other direction a little bit, there is a viewpoint -- well, there are two parts to it. Let me take this part, which is that you -- inevitably, there's going to be a huge mortgage market. We have $10 trillion -- who knows? -- it will be bigger in the future.

At some future time, maybe 20 years from now, there might be another housing crash like this one. Okay.

So that risk, then -- who's going to bear that risk? Is that going to put our financial system under stress, even if we have no Fannie and Freddie? And is there a role for the government to provide emergency assistance when you get that kind of crash of the housing market? Or are there -- and I think there are things you're trying to build in which would make such a crash less damaging.

SECRETARY GEITHNER: All financial crises, of course, have at their center -- most do -- this combination of real estate busts and bank mistakes. And we're not unique in that context.

To make sure the system is more stable in the future, more resilient against the risk of future recessions or house-price booms and busts, you need to have a system where, again, banks hold more capital against risk, people have more equity in their homes, and the government is not creating incentives that magnify the change you have these huge imbalances, overinvestment in housing over time.

Now, I think it's worth noting that, at least my view is that even if you get that stuff substantially better -- and we will. I'm sure -- I'm very confident we can do that -- we're still going to have recessions in the future.

And you want to be very careful you don't leave the country vulnerable, as we were in this crisis, to the risk that a shock that causes a recession turns into a crisis of these dimensions. And that requires there be some capacity for the government to step in and protect the economy from the collateral damage that can come from that sort of crushing de-leveraging, big withdrawal of private capital, that happens in crises.

But, of course, doing that is terribly difficult. Governments don't do that well. People think guarantees are cool and interesting, but they're very hard to do in a way that doesn't create the risk that political forces end up making them too generous, too cheap, and undermining these incentives to get a better balance of risk-taking.

So, in thinking about the future -- and this is why we laid out the options we did -- it's very important for people to think through the design questions so, again, we don't end up recreating some of the same risks that got us in this mess.

MR. BAILY: Could you say a word about the role of securitization in this?

Historically -- or at least for the last 20, 30 years or so -- the U.S. has been a large capital importer. I think probably you and I would like it better if we had a smaller trade deficit and less of a capital important. But it looks like --

SECRETARY GEITHNER: Half what it was at the peak, I just want to say.

MR. BAILY: Sorry?

SECRETARY GEITHNER: Our current account imbalance is half what it was at the peak.

MR. BAILY: Half what it was at the peak.

SECRETARY GEITHNER: Americans are saving more.

MR. BAILY: Right direction.

SECRETARY GEITHNER: That's a good thing.

MR. BAILY: Definitely. Definitely.

But anyway, we are somewhat reliant on inflows of capital, and securitization therefore tends to play an important role if that inflow is going to support the housing market at all.

We got into a lot of trouble with securitization. Non-transparent CDOs -- you talk a bit about that in the paper.

Could you say a bit more about how do we revive -- do you think we should revive securitization? How do we revive securitization? And how do we stop it getting into trouble the way it got into trouble in this crisis?

SECRETARY GEITHNER: My view is that we should make -- we should preserve a financial system in which banks are a substantial source of credit, but not the only source of credit, and their role is complemented by a capital market, including securitization market, that can complement the classic role of banks.

We are somewhat unique in that design of a financial system. And making sure that it works over time requires the type of reforms I laid out -- to make sure the incentives are better in the securitization market, and that the design of capital requirements and other things like that are more evenly applied and better calibrated to take into consideration the risks of the extreme crisis in the future.

But I think those are achievable reforms. I think it's pretty clear what we got wrong in the basic securitization market. And there is, I think, a lot of consensus on changes that would make a big difference.

And I would not support trying to create a system where banks are the overwhelmingly dominant source of credit. I think that would leave economies more vulnerable to the inevitable problems that come with banking -- you know, familiar problems to many in this room about banking. And that's true.

But, again, just to go back to one thing. You know, again, there were a lot of mistakes in how we designed the housing market. But, you know, at its core, this crisis was caused by a whole range of people -- lenders, homeowners, investors, policymakers -- not imagining the possibility of a severe recession that would include a very sharp rolling housing crisis.

And central to anything about a reformed financial system is that you make sure that the capital regime, the oversight regime, credit rating processes build in more care and caution about the risks of the severe event in the future.

MR. BAILY: In the paper you talk about wanting to move to a 10 percent down payment regime. So -- two questions.

Is 10 percent enough? Some people say we need 20 percent, which a lot of countries have.

And the second is how do we deal with the sort of second-mortgage issue that people, in fact, say they're getting a 10 percent, but then the primary mortgage holder doesn't know that there's a second mortgage on top of that.

So talk a little bit about -- what I think is right, we need to get the loan ratios in the right place. How did you set 10 percent? How are you going to enforce something like that?

SECRETARY GEITHNER: I think fundamental is, again, this basic proposition that home owners have to hold more equity in their homes, and they have to build in a greater cushion in their homes and we want underwriting standards and whatever the role the government's playing to make sure they're reinforcing that basic process.

Now, what the report says is that we think that we think that if you think about Fannie and Freddie for the initial stages of this transition, there should be a combined limit LTB -- combined limit at 90 percent, and again I think there's an overwhelming case for moving the system gradually over time to a world where homeowners hold more equity in their homes.

Now, there are costs to doing that and, you know, there's, like, hundreds of stories of businesses started in this country financed by people being able to borrow against the value of their equity at inception, not just on their credit card but against their home, and we're going to have to figure out how to make sure we don't go to far in the other direction because, you know, again, ultimately what's the right -- what's the critical test of a financial system. You really want to make sure that it has the possibility of channeling the savings of Americans and investors around the world to finance innovation, including -- and all innovation comes at that initial level, you know, in the garage, classically, or somewhere; and I think that we've got to be careful we don't push the balance too far.

MR. BAILEY: We've mentioned already a little bit about rental housing, but part of what you are saying in this White Paper is that maybe we went too far on the home ownership and we need to make sure that people who want to rent or it's better for them to rent have the opportunity to rent. So, what is the plan to improve access to rental housing?

SECRETARY GEITHNER: Well, that's a matter my colleagues at HUD are going to be principally responsible for shaping, and I'll leave it to them. We make some initial suggestions in the paper, but again the fundamental point is too much of the assistance the government's provided to individuals went to homeowners, and there's a fundamental unfairness in that. And so we think that we should alter the balance where the government's going to provide a subsidy in a way that redresses that basic unfairness.

MR. BAILEY: You have laid out some options. Could you just clarify for us what are the options that you're laying out for Congress to consider?

SECRETARY GEITHNER: Well, I want to start by just making one observation, which is if you look across countries, people do this in different ways. And in a sort of simple way you could say there was our model where you had a variety of quite broad-based and very poorly designed guarantees by the government, explicit/implicit, alongside a private market. And you have at the other extreme in lots of countries a system where banks really hold an overwhelming share of mortgage risk. And people tend to think about this as a world where there's a guarantee, and there's not a guarantee. But that's not the right way to think about it.

In the alternative model where banks hold all the risk, the governments are providing a guarantee. They're just doing it through that classic, broad support for the banking system. They don't charge for it; it's not explicit; and it has a lot of other risks to how you think about financial stability in this context.

Now, some people say well, you can manage risks in banks more carefully, more easily. We understand the risks there better, which may be the case although, as you saw, that's not as easy as people think. So, the choice is not really between are you going to provide a guarantee or not. It's in designing it so that where it is it's explicit; the taxpayers aren't too exposed; you're not creating bad incentives for investment and for risk taking. And that's sort of I think a helpful context.

But, again, the three broad options we lay out are what we call the FHA-only model, where the government's role is limited to a guaranteed mortgage that would only be available to people up to the median income.

The second option we laid out as a complement to that is what you might call an emergency backstop framework that we've deployed only in the context of a crisis. A good example of this is the suite of facilities that the Federal Reserve -- and it's nice to see Don Kohn here -- put in place in fall of '98 and in early '09 to provide a basic backstop for markets. And in that context the way that would work is you'd set up this mechanism whereby the market would be more willing to provide financing to mortgages, because there would be a backstop in place temporarily. And if you get the pricing in that right, as things improve demand for the backstop will recede and you can wind down these facilities as things improve as the Fed did so deftly in the crisis.

A third option -- and there are a lot of proposals in this arena, in this neighborhood -- is a fundamentally redesigned, much more limited guarantee or reinsurance mechanisms where there would be a lot of private capital ahead of the government and the markets would be charged a fee for that guarantee. It would be explicit by the government, but the taxpayers would be behind a lot of private capital, and if the government mis-priced the guarantee and was exposed to loss, that would be recouped in the form of a fee on the broader market over time. It has some similarities to the FDIC regime -- deposit insurance regime -- although it's much more complicated to do in this context.

So, again, our view is that that's the credible set of options, but you can't think of them in isolation, and it's possible of course that what we'll do in the end is decide on a mix of those options. And, again, you have to think about them in terms of what risks do they pose to the taxpayer? How difficult is it going to be to design the guarantee in a way that doesn't, again, get the incentives wrong and leave the taxpayer too exposed? What kind of protections do you want to build in for the country in the next crisis? And whether that can be provided through just an emergency backstop mechanism or requires the government taking, even in normal times, some of the extreme risk of credit and mortgages off the burden of the private market. But that's a mix. And, you know, we're in the -- I would say a lot of ideas in those dimensions and, again, just to (inaudible) by the challenge, for this to be done well, you have to take it away from politics. You can't -- no, you can't take it anything from politics, but, you know, you -- we have taken monetary policy away from politics. Hugely important fundamental reform in central banking. It would be nice to take fiscal policy away from politics, but that's not foreseeable. But, you want to -- if you're going to do this, you're going to get in this mechanism of designing a guarantee and you have to make sure that the people charged with doing it will be more independent from political affection, enthusiasm, influence than our system proved to be before.

MR. BAILEY: You're sort of talking about a pretty staged-out wind-down for Fannie and Freddie. It would be over several years. And, actually, I personally think that's inevitable; you've got to do that. But I think someone could look at that and say ah, you know, on both sides of the aisle that people complain Fannie and Freddie but at the end of the day they want those mortgages, because they're so important to their constituents and you're going to put off for three years, five years, six years, and actually this is never going to happen. What would be your answer to that?

SECRETARY GEITHNER: Well, I think it's a good question. Of course, any framework -- let's think about fiscal policy -- any framework where you're promising future virtue will suffer from credibility issues. But this is really the only way you can do it. And what we're proposing -- we let out the first stage of more economic pricing, more sensible set of in initial reforms to get the economics better, and what we're suggesting is the FHFA, which has the legal authority over this for Fannie and Freddie, and the FHA layout to the market an indicative transitional path for comment, in a sense, for feedback. And then they can lay that out. The market can sort of figure out what that path is. We have to revisit over time, because we won't have perfect knowledge about how long this process of repair will be or where the pricing should end up. And I think that will help reinforce the momentum, the change, and make it harder for people ultimately to step back from that transition.

Now, again, we have some important things working in our direction apart from the general recognition that this system is untenable, and that is that they don't want the taxpayer expose loss in the future and they recognize the model we have is fundamentally unacceptable. And the option of doing nothing, leaving ourselves only with the legislative authority that exists in what's called HERA, I think would put us in the position where we risk recreating a lot of flaws in the system we created then.

Again, one of the virtues of doing this -- you know, we did financial reform when the crisis was still burning in the United States, and we did that in part because we thought that you want to act when there's still a substantial amount of political will. And I'd say the same thing in housing. You don't want the process of reform to wait until things are fundamentally better and the memory has receded, although it'll take a long time for the memory of this to recede. So, I think that's another reason for wanting to move now, and although we're starting with this White Paper, we don’t want legislation to be too far deferred. We can do this initial transition thing in without legislation, but ultimately we’re going to have to explain to the market what the end game is going to be, and we can’t wait too long to lay that out.

MR. BAILEY: So, Fannie and Freddie will remain as government held utilities in this transition period?

SECRETARY GEITHNER: They will. And they have to.

MR. BAILEY: Yeah.

Okay, let me take a question or two from the audience.

Yes, Karen.

MS. DYNAN: Karen Dynan from Brookings.

So, your paper lays out several alternative proposals and we’re going to see more alternatives laid out over the course of today’s conference. So, all told it seems like we might be a ways away from locking in on a plan. So, I was wondering if I could just build on your last response. Do you think this lack of a plan is hindering the mortgage market recovery during mortgage origination and securitization while at the same time increasing the government’s exposure to risk?

SECRETARY GEITHNER: I think the three things that are still, you know, in the way of broader recovery are, one, the economics of what the government’s doing now, because what the government does now in mortgages is more attractive economically than what the market’s willing to do and so you’re right, but that’s why we want to begin the process of changing the pricing and the LTVs conforming limits in a way that will help facilitate that transition.

The second thing is lack of clarity about what the broad rules of the game are going to be over the rest of the prime market for mortgages. You know, the Dodd-Frank Act requires a pretty complicated set of rule-writing exercises across the board and where the responsible agencies are starting to lay that out. But until that is in place, people can see them. Those final rules people can see. It is going to be harder for banks to say how much capital they want to put against this and for investors to decide what role they want to play in this, so that's a necessary precondition.

And the third is, you know, just realistically just a little bit of time. I mean, you know, again, we're three years into the process of adjustment of housing markets. We probably have three more years left. And, you know, we're still pretty close to a deeply damaging financial panic. So, we need a little -- we need to just have a little more time for that uncertainty about the future to be reduced a bit, and I think those things require a little bit of time. But I think we lay out, at least notionally, a three-stage plan with that initial stage of the first steps in walking about the government's role, comes alongside, putting in place these broad rules of the game over the private market. And then we say two to three years again, because we sort of feel like the housing market still needs another two to three years to recover.

And then the second stage, which could accelerate that process of transition and ultimately, you know, have to choose this framework.

I think, again, our suggestion is that Congress try to legislate the next two years, even though you don't have to lock in that successor regime until probably five to seven years from now. The way we describe this is, you know, we're all -- we're going to drive west. We're driving -- everybody wants to go west; we sort of know where we're going to go, but somewhere around Salt Lake City we'll make a choice about what mix of ultimate options.

MR. BAILEY: Questions. Here.

Alice.

We have a microphone?

MS. RIVLIN: Alice Rivlin, Brookings.

Your paper basically supports the role of the government in affordable housing, both rental and home ownership, and suggests that we do it on budget, we appropriate amounts for this rather than try to hide it somewhere. And that all seems to be good. But in a moment of great budget austerity when everything's going to be facing cuts, won't it be sort of a hard sell to set up new kinds of programs that are oriented toward affordable housing?

SECRETARY GEITHNER: I do think it will. But, as you know better than anybody, you know, our long-term fiscal sustainability problem is fundamentally about long-term entitlements, particularly that costs of health care, and I think there is -- we as a nation can absolutely afford to make and commit to a set of targeted assistance for low, moderate-income Americans. And I think the challenge, again, is to do that in a way where it's more targeted and more transparent and on budget and a little more fair between renters and homeowners. But I think that's something we can afford. You know, as you know better than anybody, we can't -- we're not going to solve our long-term fiscal problems just by spending less of what we call nondefense discretionary spending. We are going to spend less in that area, and we're going to demonstrate substantial restraint in those areas, but we're still going to have to make sure we can sustain the capacity and we can afford it to make sure we're making investments in things that are critical to our capacity to grow in the future and to make sure we're providing broad opportunity to Americans across the income spectrum. So, I think it's affordable. But, you're right; the politics of all that stuff will get much harder.

MR. BAILEY: Good. Thank you very much, Secretary Geithner. I really appreciate your coming here. That was terrific. Good job.

* * * * *

CERTIFICATE OF NOTARY PUBLIC

I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

/s/Carleton J. Anderson, IIi

Notary Public in and for the Commonwealth of Virginia

Commission No. 351998

Expires: November 30, 2012