Written Testimony of

Adam J. Levitin
Professor of Law
Georgetown University Law Center

Before the United States Senate Committee on Banking, Housing, and Urban Affairs

“Chairman’s Housing Reform Outline: Part 1”

March 26, 2019
10:00 am
Witness Background Statement


Professor Levitin has previously served as the Bruce W. Nichols Visiting Professor of Law at Harvard Law School, as the Robert Zinman Scholar in Residence at the American Bankruptcy Institute, and as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP). Professor Levitin has also previously served on Consumer Financial Protection Bureau’s Consumer Advisory Board.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College. In 2013 he was awarded the American Law Institute’s Young Scholar’s Medal.

Professor Levitin has not received any Federal grants or any compensation in connection with his testimony, and he is not testifying on behalf of any organization. The views expressed in his testimony are solely his own.
Mr. Chairman Crapo, Ranking Member Brown, Members of the Committee:

Good morning. Thank you for inviting me to testify at this hearing. My name is Adam Levitin. I am a Professor of Law at the Georgetown University, where I teach courses in structured finance, consumer finance, bankruptcy, and commercial law. I appear here today as an academic who studies housing finance, without any economic interest other than as a homeowner.

I am deeply concerned about the basic direction of the Chairman’s housing finance reform proposal outline. Today’s housing finance market is functioning well. Most creditworthy Americans are today able to obtain mortgage financing, no matter where they live—metropolitan areas or rural communities. They can readily obtain a long-term fixed-rate mortgage, the product that has built the American middle class. They can lock in an interest rate prior to closing, so they can budget a home bid with confidence. And they can choose to get their loan from thousands of institutions, including their local community banks and credit unions.

The multi-guarantor system proposed in the Chairman’s outline would place all of this in jeopardy. Specifically, a multi-guarantor system as envisioned will result in:

1. rural consumers being unable to obtain credit on equal terms to urban peers;
2. consumers being unable to get 30-year fixed-rate mortgages on competitive terms;
3. consumers being unable to readily get pre-closing rate locks;
4. small lenders being shut out of access to the secondary market; and
5. an unstable, procyclical market that will put taxpayer funds at risk.

While my prediction here is dire, it is hardly speculative. Much of this is what happened during the 2002-2008 housing bubble period, as well as in the pre-New Deal mortgage market.

For example, how did Countrywide Financial and Washington Mutual and other private-label securitization sponsors grow their market shares in the bubble years? By lowering their underwriting standards, such that the risk-adjusted price of mortgage credit fell, even as the supply expanded. Private-label securitization financed primarily nontraditional mortgages, not 30-year fixed-rate loans, and private-label MBS were insufficiently standardized to trade to-be-announced (TBA) market that enables lenders to offer pre-closing rate locks. By the end of the bubble, we started to see private-label MBS with geographically concentrated pools, such that if the bubble had gone on longer, a national market would have ceased to exist. And the massive underpricing of risk in the private-label MBS market enabled borrowers to bid up home prices to an unsustainable level, making a crash all but inevitable.

---

The lesson from the bubble is that secondary market competition for credit risk can be deleterious. A multi-guarantor system produced harmful competition among guarantors for credit risk because it will result in market segmentation and pro-cyclical pricing.

Fortunately, there’s a ready fix to the problem based on one essential change: ensure that guarantors are taking on market-wide credit risk, rather than the credit risk on a segment of the market. If guarantors assume market-wide credit risk, the market will not segment and guarantors will not price pro-cyclically. This is best achieved through a single-guarantor structure combined with back-end synthetic credit risk transfers (CRTs). Such a structure would be a formalization (with some important adjustments) of the current, well-functioning system, which is a single-guarantor system in all but name.

I elaborate on these points in the remainder of my written testimony.

I. FIRST, DO NO HARM

The prime directive in dealing with the housing market should be “do no harm.” The housing finance system we have today works quite well. We should not overlook this fact. Most creditworthy Americans are today able to obtain mortgage financing. Moreover, under the current system, there is:

1. a national mortgage market with access to credit on substantially equal terms everywhere in United States;
2. widespread availability of the 30-year fixed-rate mortgage;
3. a viable to-be-announced (TBA) market that enables consumers to get pre-closing rate locks;
4. systemic stability;
5. competitive small lender access to secondary markets; and
6. support for affordable mortgage credit for low-to-moderate income households.

In other words, the current system is producing the outcomes that should be sought in any housing finance system; these are the metrics by which any housing finance system should be judged.

Yes, Fannie and Freddie are still in conservatorship, and that requires figuring out their future, but we have already seen considerable advances in housing finance reform. These reforms started with the Housing and Economic Reform Act of 2008 and have continued with the substantial operational changes Fannie and Freddie have undertaken while in conservatorship, most notably their adoption of various credit risk transfer (CRT) transactions to shift credit risk on mortgages to capital markets and other investors.

---

2 The TBA market is a market that trades forward contracts for mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae. The settlement dates for TBA trades are often months after the trade, so lenders are able to hedge the interest rate risk on mortgages that they have committed to, but not yet funded. This enables lenders to offer borrowers a pre-closing rate lock on the mortgage.
As a result of these reforms, Fannie and Freddie have been substantially derisked. Moreover, the mortgage market as a whole has been substantially derisked through the broader legislative reforms of mortgage lending in title XIV of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the subsequent activity of the Consumer Financial Protection Bureau. The reformed housing finance system we have today is working, and we should be very cautious before we undertake a wholesale revision of the system, particularly when there is not consensus about the right way to proceed.

Unfortunately, as explained below, the multi-guarantor system, as envisioned by in the Chairman’s outline, will fail at all of these metrics because of the destructive nature of competition among guarantors.

II. Competition Can Be a Bug, As Well As a Feature

The starting point for the multi-guarantor system envisioned in the HRO is that there should be competition among guarantors for credit risk. The conceit is that as long as there are enough guarantors in the market, no guarantor would be “too big to fail,” and therefore market discipline resulting from competition is not to be feared.

While competitive markets are generally a good thing, competition can have deleterious effects in some circumstances. One needs look no further than Wells Fargo’s false account scandal; the intense competitive pressures on Wells encouraged corner cutting and worse.

A similar concern exists in housing finance markets, where competition for market share can result in a race-to-the-bottom for credit risk. This was, in essence was happened during the housing bubble. Historically, Fannie and Freddie never really competed with each other on credit risk; their underwriting guidelines were always closely aligned. The growth of private-label mortgage securitization after 2002, however, created alternative secondary market executions that competed on credit risk. The result was a classic underwriting race-to-the-bottom (the equivalent of an insurance rate war), because the way for the investment banks that engaged in private-label securitization to gain market share was to lower underwriting standards and/or underprice for risk. Multiple investment banks competed with each other to securitize mortgages, and they pushed Fannie and Freddie into competition for market share too. The resulting glut of underpriced mortgage credit fueled the housing bubble.

The housing bubble was the product of competition for credit risk in housing finance in order to generate profits. Pursuing a multi-guarantor model simply takes us right back to a new iteration of the disastrous private-label market. Specifically, two adverse consequences will follow from secondary market competition for mortgage credit risk. First, competition will segment the market. And second, competition for credit risk will produce pro-cyclical pricing that will result in unsustainably inflated home prices.

© 2019, Adam J. Levitin
A. Competition Will Segment the Market Geographically and Render the 30-Year Fixed Uncompetitive.

As guarantors compete for market share, they will be under enormous pressure to engage in risk-based pricing. Risk-based pricing makes sense in some circumstances—a borrower with a 740 FICO should not be paying the same rate as an otherwise identical borrower with a 520 FICO score. Yet risk-based pricing also segments markets, and certain types of market segmentation are undesirable, as discussed below.

In particular, risk-based pricing unwinds cross-subsidization, yet certain types of cross-subsidization are desirable in the market, namely when the behavior being subsidized has positive spillover effects on the entire market. Thus, we should want to subsidize mortgage products that promote financial stability, and risk-based pricing prevents such subsidization.

The Chairman’s outline envisions that FHFA will regulate the guarantors’ pricing, but it is hard to imagine that FHFA would not permit risk-based pricing; if it does not, there is no way for the guarantors to distinguish their offerings based on price, and at that point what is the purpose of having multiple competing guarantors?

1. Competition Among Guarantors Will Destroy the National Market

Risk-based pricing may segment markets geographically, destroying the national housing finance market and drying up credit for rural America. Currently we have a single national market. Similar borrowers can obtain credit on substantially similar terms no matter whether they live in an urban market or a rural market. This is in part because of cross-subsidization within the system. Currently rural mortgages are subsidized by urban borrowers, just as free rural delivery of the mail is subsidized by urban customers.

Just as all Americans benefit from rural consumers being able to participate on equal terms in a national informational market through free rural delivery, so too do all Americans benefit from subsidization of rural mortgages. Smaller mortgage markets are inherently less stable, just as a smaller insurance pool would be, because smaller markets are less able to spread risk. For example, suppose that instead of a national mortgage market, there was an Iowa mortgage market. If there were a bad soybean harvest one year, the spike in defaults might result in the collapse of the entire Iowa mortgage market. But because Iowa is part of a national market, there is the ability to weather a bad soybean harvest. National markets enable risk-spreading, which benefits all consumers with greater market stability, but national markets make some level of cross-subsidization inevitable.

Competition will spur guarantors to engage in risk-based pricing, and if this is geographic risk-based pricing, there will quickly be a metropolitan market and a rural market. In that metropolitan market, there will also be an affluent (white) suburban market and a lower-income (minority) urban market. In short, we will return to the pre-New Deal world

---

3 I am not referring to USDA rural development loans, but simply to conventional mortgage loans made to borrowers to lower-population density regions of the United States. Two key factors add to the riskiness of rural loans. First, appraisals are less reliable because of fewer comparables. Second, rural property values are often tied to the state of the agricultural or extractive economy in a way that metropolitan property values are not tied to a single industry.
of localized mortgage credit markets, with significant disparities in credit terms between markets, and greater instability in all markets.

Once there is segmentation, there is also likely to be cream-skimming, in which guarantors simply cease serving riskier markets. Borrowers in “riskier” markets, such as rural America, will pay more . . . if the market will continue to serve them at all. Rural communities will be at risk of becoming second class citizens in the mortgage market. At the same time, however, those borrowers in other “safer” markets will themselves be at greater risk because they are now part of a shallower and less diversified market. 4

In short, geographic risk-based pricing destroys the positive externality of systemic stability that comes from a broad national market. And it is contrary to a fairness principle that every creditworthy borrower—urban or rural—should have the same chance of owning a home responsibly.

Yet it is hard to gainsay the likelihood of geographic risk-based pricing in a multi-guarantor system. There will be tremendous market pressure for it and FHFA can hardly forbid it, given that FHFA authorized already authorized it for Fannie and Freddie in the form of the Adverse Market Delivery Charges that penalized states with more robust consumer protection laws.

2. Competition Among Guarantors Will Render the 30-Year Fixed Rate Mortgage Uncompetitively Expensive

Competition will also spur guarantors to price adversely to mortgage products that entail greater risk for lenders: including longer-term mortgages (because amortization is slower) and fixed-rate products (because these are likely to be refinanced and thus cease to generate guaranty fees). This means that guarantors are likely to price adversely to the 30-year fixed rate mortgage, such that the 30-year fixed will become uncompetitively expensive relative to other products.

While the 30-year fixed is not the right product for all borrowers, it is the crown jewel of the American housing finance system. The 30-year fixed is a uniquely American product, and it has been the bedrock of US housing finance markets since the 1950s for good reasons:

• The long term and free-prepayment ability has given homeowners substantial financial freedom (“optionality”). The homeowner can pay off the mortgage if she moves or keep it while staying in the house without having to refinance or payoff the loan;
• The fixed rate enables households to budget around what is typically its largest monthly expense;
• The fixed rate shields households from interest rate risk, which consumers are otherwise ill-prepared to address;
• The long term also keeps down monthly payments, which gives households’ economic flexibility and increases housing affordability;
• Full amortization means that households are constantly building equity and avoid balloon payments;

4 Geographic risk-based pricing may also raise fair lending issues.

© 2019, Adam J. Levitin
• The 30-year term lets households telescope 30 years of future earning power (roughly the time from household formation to retirement) into current purchasing power.

No other mortgage product has so many benefits for both households and financial market stability. The 30-year fixed is the financial product that built the American middle class and made America a nation of homeowners.

Competition among guarantors for credit risk will make the 30-year fixed as more expensive and disfavored product. This is not idle speculation. The last time we saw vigorous competition for mortgage credit risk—the housing bubble years of 2002-2008—were also marked by the abandonment of the 30-year fixed in favor of non-sustainable, non-traditional mortgage products financed through private-label securitization.

The 30-year fixed is not a naturally occurring product—it exists only because of extensive government intervention in the mortgage market. The 30-year fixed has a positive stability externality on the entire mortgage market. But that externality cannot be captured by any individual lender, so lenders do not account for it. That is why, left to their own devices, lenders worldwide eschew long-term, fixed-rate mortgages. The 30-year fixed is an example of government intervention to create and then preserve an important positive systemic stability externality.

3. Competition Among Guarantors Will Undermine the TBA Market and Prevent Consumers from Getting Pre-Closing Rate Locks

The Ginnie Mae wrap envisioned in the Chairman’s outline would standardize credit risk on all MBS across guarantors, but it would not standardize interest rate risk. Rate risk relates in part to the product characteristic and borrower characteristics; prepayment speeds are different for different products and based on different borrower characteristics. To the extent that guarantors differentiate themselves with specialization, there will be different prepayment speeds associated with different guarantors. For example, one guarantor might specialize in 3/1 hybrid ARMs and another in 7/1 hybrid ARMs and another in 15-year fixed rate mortgages, each associated with a different prepayment speed.\(^5\)

If different guarantors are associated with different prepayment speeds, then Guarantor A’s MBS will not be good delivery for Guarantor J’s MBS or Guarantor Z’s.\(^6\) As a result, there will not be one national TBA market, but a separate TBA market for each guarantor, and that might result in no TBA market whatsoever. The TBA market exists because it is a deep and liquid market. If the TBA market were splintered into a dozen smaller markets, none of them would have the liquidity to support a reliable forward contract trade. As a result, lenders would not be able to hedge out their rate risk between the time a consumer is approved for a loan and closing. Lenders would likely stop offering rate locks

---

\(^5\) 3/1 hybrid ARMs (a 3-year fixed-rate period followed by annual readjustments of the interest rate) will generally have a faster prepayment speed than 7/1 hybrid ARMs (a 7-year fixed-rate period followed by annual readjustments of the interest rate) because of the self-selection of borrowers into a loan with a shorter fixed-rate period indicates an intention to move before the fixed-rate period expires.

\(^6\) A Ginnie II structure would mitigate some of this as Ginnie II MBS are blends of different seller/servicer MBS, but the particular blends will still vary. If there is enough variation, the MBS will not be good delivery for each other.
for consumers, leaving consumers exposed to rate risk and potentially causing home sales to fail because of a financing contingency.

**B. Competition Will Result in Procyclical, Unstable Housing Finance Markets**

Housing is an inherently incomplete and inefficient market with enormous externalities. Because of these differences, housing finance markets cannot be expected to function like other, normal markets.

First, housing markets are incomplete markets because housing cannot be shorted directly. A complete market should allow investors to express both long and short positions; if only long positions are available, prices will be skewed upwards. Housing markets cannot be shorted directly because the short seller cannot meet its delivery obligation because it cannot acquire the house even if the house price falls. This means that there is only long pressure on home prices; there are no direct shorts in the residential real estate market.\(^7\)

Second, and relatedly, housing is not a liquid asset. Part of this is that housing is not standardized, and part is that there are high transaction costs in the sale and purchase of housing. But part is simply that homeowners are not looking to buy and sell all the time because houses are not just a financial asset, but a consumable source of shelter. This means that home prices are slow to adjust up or down compared to the stock market.

Third, home prices are correlated geographically and serially. The value of my house affects the value of neighboring houses and vice-versa. This is geographic correlation. For example, if I leave a rusting car up on cinderblocks on the front lawn, it will diminish the value of my neighbor’s house, whereas if I plant a beautiful garden, it will increase the value of my neighbor’s home. Similarly, if my house goes into foreclosure, it will push down the value of neighboring homes. In contrast, the value of my car generally does not affect the value of yours. If I don’t wash my car, it has no impact on the value of your car, and if I trick out my ride with a sweet new stereo system and fancy rims, the value of your car won’t budge.

Likewise, home pricing is correlated serially. Most homes are purchased on credit, and the amount of credit lenders will make available depends on the lender’s valuation of the house, the loan-to-value (LTV) ratio. Valuations are based on appraisals, and appraisals are generally based on the sale prices of comparable properties. So if housing prices have been rising for a type of property—say split-levels in the neighborhood—then appraisals will also go up and lenders will make more credit available while holding the LTV constant. The result is that the prospective buyer will bid up the house price, thus making home prices serially correlated.

Finally, housing is different because the value of my house (and hence yours given the geographic correlation) depends in part on the credit terms I receive, the constraints to borrowing or the lack thereof. Because most homes are purchased on credit, credit terms are major determinants of home pricing.

---

\(^7\) One can take a short position on housing derivatively through a credit default swap (CDS) that references a mortgage-backed security (MBS) or index of MBS, but it is not a short position on a particular mortgage or market, but rather on the set of mortgages that back a particular MBS or the MBS represented in the index.
If credit terms are tightened due to an exogenous shock, housing prices will fall. Guarantors will respond to a falling market by tightening credit terms, further destabilizing the market. Guarantor X does not care what effect its risk premia have on the value of a home that is collateral for lender Y. Lender X is simply concerned that it price in the risk of the falling market for itself, without regard that its pricing will have a pro-cyclical effect that will harm guarantor Y. More generally, neither lender X nor lender Y cares about the systemic risk externality that results from overly risky lending practices. The only way that the systemic externality will be priced is when a party bears the risk of the entire mortgage market. Any segmentation of the market will fail to price for the risk.

Unstable markets also undermine the basic conceit of the multi-guarantor system: that no guarantor will be “too-big-to-fail.” Yet the instability a multi-guarantor system will generate will affect all guarantors, and the fact that they will be monolines will ensure that they are all equally exposed. Thus, a multi-guarantor system raises the possibility of correlated failure, such that it will not matter that no entity is “too-big-to-fail” if the entire system goes down.

C. Competition Among Guarantors Will Cut Off Secondary Market Access for Small Lenders

A multi-guarantor system would also disadvantage small lenders—community banks, credit unions, and small mortgage banks. The Senate Banking Committee often expresses bipartisan concern about the disappearance of community banks, but it is hard to think of a reform that would be more devastating to community banks, credit unions, and small mortgage banks.

Under the current system, small lenders are able to sell their mortgages directly to Fannie and Freddie at a “cash window,” meaning that they can be paid in cash, rather than in the form of Fannie/Freddie MBS, which they would then have to sell. Many small lenders are not set up for selling MBS themselves.

A multi-guarantor system would not necessarily have any “cash window.” Instead, small lenders that want cash might have to either sell to an aggregator—which would take a middleman’s cut, thereby reducing the profitability of mortgage lending for small lenders—or sell to a guarantor.8

There is little reason, however, to expect guarantors to want to serve small lenders. Guarantors assume credit risk on lenders because the lender makes various representations and warranties about the mortgages that it sells or gets guaranteed. If the loans fail to conform to the representations and warranties, then the guarantor must look to the lender to recover any resulting damages. As a result, guarantors have an interest in the financial strength of the lenders with which they do business. $10 million in representation and warranty claims is immaterial to a megabank like Chase or Wells Fargo, but it might be

---

8 Nothing in the Chairman’s outline would prevent aggregators or guarantors from being affiliates of megabanks, which would mean that the megabank could then leverage its mortgage purchase to attempt to cross-sell the consumer and take business away from the community bank.
catastrophic for a community bank. As a result, guarantors will prefer to do business with large lenders. Moreover, the cost of conducting diligence on a lender is roughly the same irrespective of lender size, so guarantors are incentivized to prefer dealing with large-volume lenders.

The Chairman’s outline would prohibit guarantors from offering volume discounts, but it does not undo the fact that guarantors have reasons to prefer dealing with larger lenders. Guarantors can readily find other ways to prefer larger lenders, however. For example, guarantors could have different lender approval standards for large and small lenders. Guarantors could offer lower rates for larger lenders (based on the lender’s size, rather than sale volume). Guarantors could demand fewer representations and warranties from larger lenders. Guarantors could have sufficiently complex servicing requirements that small lenders could not retain servicing. Guarantors could charge more for a “cash window” execution than a swap execution. Merely prohibiting volume discounts is insufficient to ensure equal treatment of small lenders when guarantors have reason to prefer dealing with larger lenders.

As a result, small lenders are unlikely to receive the same sort of equal access as they have today in the Fannie/Freddie system. Without this equal access, small lenders will be uncompetitive in the mortgage market. The irony, then, of a multi-guarantor system is that it pushes the market toward bigness on the mortgage origination front, even as it encourages competition among guarantors. In other words, robust guarantor competition would have the perverse outcome of hurting small lenders and concentrating the mortgage market in the hands of megabanks.

D. Competition Will Harm Affordability

Normally, we think of competition as resulting in lower prices for consumers. In housing finance competition in the secondary market works differently, however. Because of secondary market competition’s negative externality on systemic stability, secondary market competition may actually increase mortgage costs as guarantors try to play catchup to price for the risk created by segmented, unstable markets. For example, suppose guarantor X has tried to gain market share in the California market by reducing its risk premia. The result will be home prices in California being bid up because of easier credit, and that in turn will boost appraisals and encourage greater lending volume from other lenders, enabling a further bidding up of home prices. So while credit might be cheaper, it will be offset by higher home prices.

Taking this scenario a step further, however, the increased home prices here are divorced from fundamentals and are thus unsustainable. Given that guarantors are aware that any other guarantor’s reduction in risk premia can set off a bubble, guarantors will start pricing for the instability created by the competition. The result in the end should be higher costs of credit because lenders have to try to price in the risk of market instability.

I appreciate that the Chairman’s outline recognizes a need for support of affordable housing for low-to-moderate income households. Broadening housing finance markets benefits everyone. It not only benefits low to moderate income (LTMI) households, but it benefits more affluent households by fostering a cohort of homeowners who can eventually
move up into more expensive housing, helping to address in part the liquidity challenges referenced above. Moreover, to the extent the market is broader, it will be more stable, just as the vast number of cars has helped the stability of our auto insurance markets.

The Chairman’s outline envisions support for affordable housing through a tax and transfer system. Such a system is not in any way inherent to a multi-guarantor structure. While the key question is what level of support would exist, I would urge the Committee to support affordable housing through cross-subsidization, rather than tax-and-transfer, as part of any approach to housing finance reform.

Both approaches can achieve the same ends. Cross-subsidization, however, allows for a nimble, market-based approach. If market entities are tasked with ensuring a certain level of LTMI lending, they will figure out how to allocate the cost of doing so among customers. This means that if there are shifts within housing markets, such as a rapid rise in home prices in a region, that market entities can adjust in real time to ensure a supply of credit to LTMI households in that region. In contrast, a tax and transfer system will inherently lag the market, just as conforming loan limits have. It gets updated only when Congress or a regulator gets around to it. All of this counsels for preferring a system of mandated levels of LTMI lending with cross-subsidization as the funding mechanism, rather than tax-and-transfer, all else being equal.

III. A SIMPLER, STABLER ALTERNATIVE: A SINGLE-GUARANTOR SYSTEM

The multi-guarantor system, as envisioned in the Chairman’s outline, will result in a procyclical and unstable housing market that will fail to provide widespread availability of the 30-year fixed or pre-closing rate locks, and will fail to provide access to mortgage credit nationwide, particularly in rural communities. This is because competition among guarantors will result in segmentation of the market and pro-cyclical risk-pricing.

A better approach is a single-guarantor system that features back-end synthetic credit-risk transfers. Such a system would involve a single entity guarantying MBS.9 This entity could be part of the federal government or have a credit line with the federal government. The MBS investors would assume the interest rate risk, while the guarantor entity would assume the rate risk. Because there would be only a single guarantor, there could not be market segmentation.10 Moreover, because the single-guarantor would be holding credit risk

---

9 A single-guarantor structure could be run through Ginnie Mac, through a public utility, or through Fannie Mae and Freddie Mac (as in our current bifurcated single-guarantor system). I do not express an opinion here on this level of design detail.

10 An alternative way to achieve market-wide risk exposure would be to require the guarantors in a multi-guarantor system to cross-guaranty each other. That is the first-loss risk would still remain on individual guarantors, but if a guarantor failed, all of the other guarantors would be jointly liable for the failed guarantor’s guaranty obligations. If, and only if all guarantors failed—that is a catastrophic failure of the entire mortgage market—would Ginnie Mae step in with its backstop. This sort of mutualization of risk is hardly novel. It is the system that has existed successfully for the Federal Home Loan Banks since 1932. It is also the basic design of clearinghouses that are used across financial markets. And it is the design of the FDIC—a private mutual insurance fund with an implicit government backstop.

Mutualization produces an enormous moral hazard—every guarantor is incentivized to engage in excessively risky behavior because part of the tab is born by the other guarantors. But because the guarantors
for the entire system, so it would be incentivized not to price pro-cyclically because such pro-cyclical pricing would only drive up defaults.

Because there would be only a single guarantor, the MBS would all be good delivery for each other and would support a robust TBA market. The guarantor entity would then swap out the non-catastrophic credit risk on the back-end through the issuance of credit-linked notes. These credit-linked notes would transfer the credit risk to capital market investors.

If adverse market conditions obtained and these credit risk transfers were not possible, the guarantor would continue guarantying mortgages, thereby ensuring a stable housing finance system, relying on the strength of the federal balance sheet. Once the adverse market conditions passed, the guarantor could engage in credit risk transfers once again, including on the whole book of mortgages it had guaranteed while the market was in turmoil.

There are several additional benefits from using back-end CRTs using credit-linked notes rather than multiple front-end guarantors:

1. The use of credit-linked notes eliminates the risk of guarantor failure that exists in a multi-guarantor system. Credit-linked notes are, by definition, pre-funded by investors, so there is no risk of the single guarantor ever getting left holding the bag except to the extent that it cannot place the credit-linked notes, which would be an indication of a full-blown market collapse.

2. The market for credit-linked note investors would be much deeper than the market for specialist mortgage guarantor entities. Instead of perhaps a dozen entities competing in the market, the credit-linked note market would be open to all manner of institutional investors and perhaps also the general public. Such a deeper market would be much more liquid and more efficient, which would help reduce the costs of mortgage financing to all consumers.

__11__ A credit-linked note is a securitization of credit default swaps. It provides a way for capital market investors to assume credit risk on a targeted asset pool without having to own that asset pool.

The way this would work here is that Ginnie Mae would enter into a credit default swap or swaps on a reference pool of mortgages with a special purpose entity that it has created. The special purpose entity would fund itself by selling notes to capital market investors (presumably all institutional investors) and, as long as the swap remained outstanding, the special purpose entity would invest the funds in Treasury securities. Ginnie would take the short (protection buyer) position and the special purpose entity would take the long (protection seller) position, such that as long as the mortgages performed, Ginnie would make payments to the special purpose entity, which would use the payments to pay on the notes to the investors. If the mortgages failed to perform to some specified level, the special purpose entity would make a payment to Ginnie, using the funds it accumulated from selling the notes to the investors.

__12__ Critically, there is no greater federal government exposure in a single-guarantor system than in a multi-guarantor system.
(3) There would be substantial operational efficiencies in having a single credit-linked note issuance program housed in a single guarantor versus a dozen different guarantors each replicating mortgage underwriting and securities issuance activities.

(4) There would be no question about small institution access to the system. Small lenders could deal with the single guarantor through a cash window, just as they can with Fannie Mae and Freddie Mac or through the Federal Home Loan Banks that serve as Ginnie issuers.

A single-guarantor approach is not novel. It is what we have today in all but name. Most of the mortgage market today is guaranteed by Fannie and Freddie, which as a single guarantor, even though they are separate entities: they are both under common control through the conservatorship, they both have capital support agreements with Treasury, their underwriting guidelines are substantially the same; and come this summer, they will be issuing a single security. Indeed, with their capital support agreements, there is effectively only one guarantor, the U.S. government.

Fannie and Freddie have also been engaged in back-end CRT transactions (Connecticut Avenue Securities and STACR, respectively) for the past six years. The Fannie and Freddie CRTs have been on geographically undifferentiated pools of 30-year fixed-rate mortgages. While the Fannie and Freddie CRTs have not been tested in a down market, Fannie and Freddie maintain the flexibility to keep supporting the market by assuming credit risk without CRTs when adverse conditions prevail.

The fact that we currently have what is a single-guarantor system in all but name has a tremendously important implication: we know that a single-guarantor system works. We have a national housing market that ensures credit availability on substantially similar terms to similar creditworthy borrowers nationwide. There is a robust TBA market, and competitive access for small lenders to secondary markets. The 30-year fixed is widely available creating broad systemic stability benefits, and the limited competition between Fannie and Freddie on the front-end of the guaranty market adds to systemic stability. More could be done to support affordable mortgage credit, but the current system has both a cross-subsidy mechanism and a tax-and-transfer mechanism in place for providing such support. A single-guarantor system is tried and true; a multi-guarantor system is not in the conventional market.

While we have a single-guarantor system in all but name, there are a pair of important reforms that should be undertaken before formalizing such a system. First, any mandate for a single-guarantor entity to use CRTs should have an adverse market condition exception that allows it to expand its own book of business countercyclically when necessary, with the expectation that they will eventually transfer the risk when market conditions settle.

Second, the single-guarantor entity should be prohibited from engaging in geographic segmentation on its CRTs. At present, Fannie and Freddie CRTs transfer risk on national mortgage pools because Fannie and Freddie each serve a national market. But nothing currently prevents Fannie and Freddie from having CRTs on more harmful, finely segmented pools, including geographically segmented pools. Indeed, Fannie and Freddie already have segmented their CRT pools into high and low-LTV pools. A single-guarantor
entity should be required to engage CRTs (subject to an adverse market exception) on the basis of its entire book of business, rather than on a segmented basis.

**CONCLUSION**

The multi-guarantor proposal envisioned in the Chairman’s outline is fundamentally flawed because it would generate destructive competition for credit risk in the secondary market that would result in an unstable, pro-cyclical housing finance system that would fail to ensure the widespread availability of the 30-year fixed-rate mortgage, fail to provide pre-closing rate locks to consumers, disadvantage small lenders, and leave rural America without adequate mortgage financing. A better approach would be a single-guarantor structure with back-end credit-risk transfers that taps into a broader pool of investors and ensures that competition for credit risk does not segment the mortgage market or produce pro-cyclical pricing.