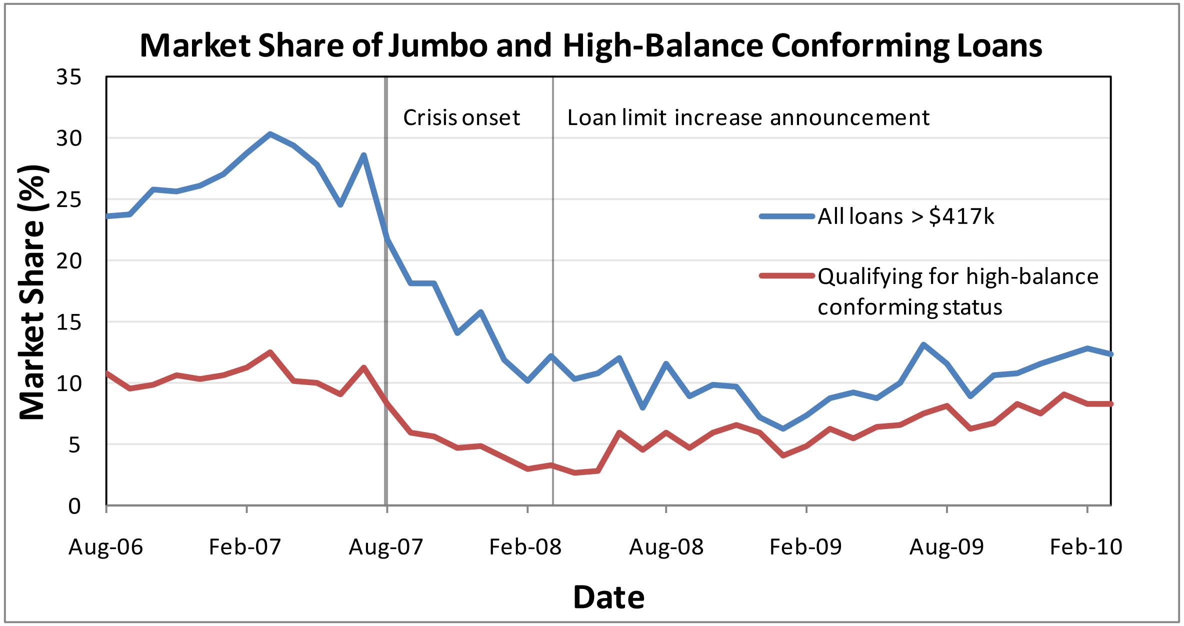
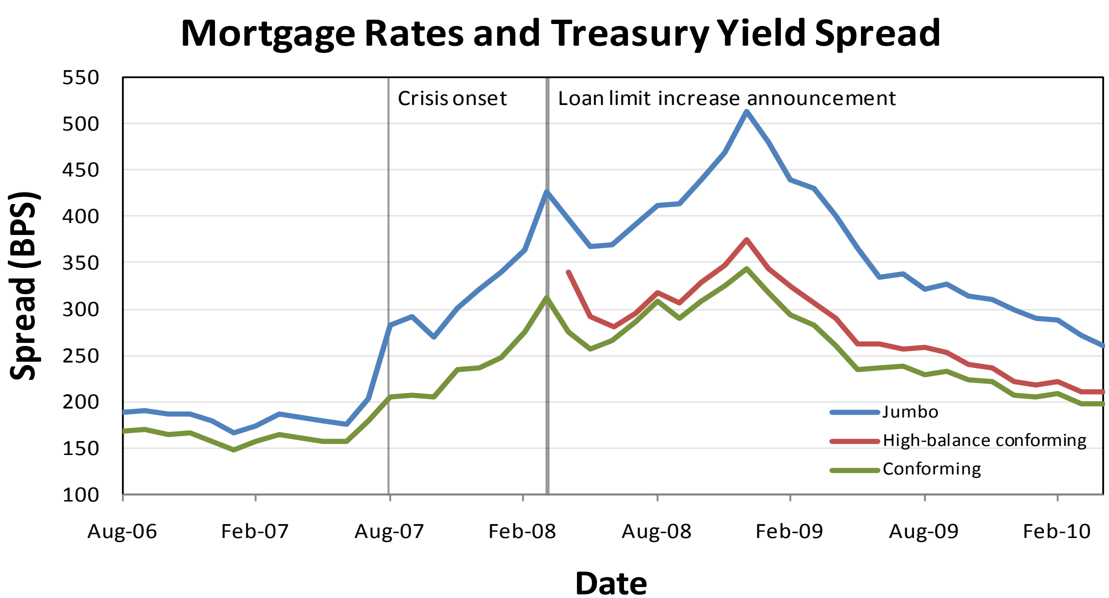
Relative Performance of Jumbo Market Over Crisis





- Conforming market was relatively robust during crisis.
- Significant impairment of jumbo market with onset of crisis.
- Two factors important for relative performance of conforming market:
    - Credit guarantees
    - Liquidity of MBS

Design principles:

- Preserve what worked well.
  - Standardized underwriting & TBA market.
- Economies of scale and scope.
  - New entities should be few in number.
  - Few economies of scope between single- & multi-family.
- Housing subsidies should be transparent and on balance sheet.
  - Focus affordable housing goals in FHA.
  - New entities focus on “core” of housing market.
- Fiscal policy should be conducted by fiscal authorities.
  - “Buyer of last resort” should be Treasury (CB can serve as agent).
- Government owns the “tail-risk” in housing.
  - Make insurance explicit and priced.

TBA Trading Links Primary & Secondary Markets

- Rate-locks
  - Borrowers can lock in a mortgage rate for 60 days before closing.
    - Exposes lenders to interest rate risk.
- Hedging
  - Lenders can hedge this risk more efficiently by selling mortgages 1-3 months forward.
    - Private label securitization requires first stockpiling loans in a conduit.
- Sources of liquidity:
  - Standardized underwriting,
  - Diversification via pooling,
  - Assumption of homogeneity via guarantees and forward trading.

TBA Market continued:

- Benefits of TBAs:
  - Enhance liquidity,
  - Reduce hedging costs,
- Requirements for TBAs:
  - Small number of issuers,
    - Privatization and fragmentation is not compatible
  - Some actual homogeneity of mortgages,
    - Standardized underwriting criteria & procedures
    - Government guarantee
  - Significant back-office operations & creditworthy counterparties.

Lender Cooperative Model:

- Mutually-owned co-op of firms engaged in residential lending.
  - Only members can sell mortgages to be securitized.
  - Members have an equity stake that serves as a capital buffer.
  - Guarantee fees used for:
    - Payment of gov't tail risk premiums,
    - Contributions to a mutualized credit loss pool.
- Design issues:
  - What are the triggers for the gov't tail risk insurance?
    - MBS level, vintage level, or size of mutual loss pool.
  - What mortgage products are securitized by the co-op?
    - Focus on a few standard products with sufficient history to price tail insur.
    - New products to be added only after proven performance.
  - How many?
    - Keep number small to preserve scale economies.

Lender Cooperative Model:

- Advantages:
  - Preserve TBA market and loan standardization.
  - Little incentive for “mission creep” or exercise of monopoly power over lenders, since profits are redistributed to members.
  - Mutual credit loss pool gives incentives for members to monitor.
  - Reduces moral hazard -- co-op takes losses ahead of gov’t.
- Disadvantages:
  - Limited access to capital markets.
  - Weaker incentives to innovate than fully private model.
  - Governance may be weaker than in other models.
    - Smaller mortgage lenders may feel disadvantaged.
    - Could limit the maximum “shares” that any member can have – cf. FHLBs.