

Information Failures in the U.S. Mortgage Market



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May 13, 2010

Fixed-Rate Mortgages & Securitization

- Most consumers have fixed incomes
 - Therefore they prefer amortized, fixed-rate mortgage obligations, all else being equal.
- Securitization is necessary for financing fixed-rate mortgages.
 - Interest rate risk for depositaries because of asset/liability duration mismatch
 - Outside of US, fixed-rate mortgages are rare, but housing markets are less stable because of rate risk on consumers
- Securitization links long-term funders with long-term borrowers.



GSE and Private-Label MBS

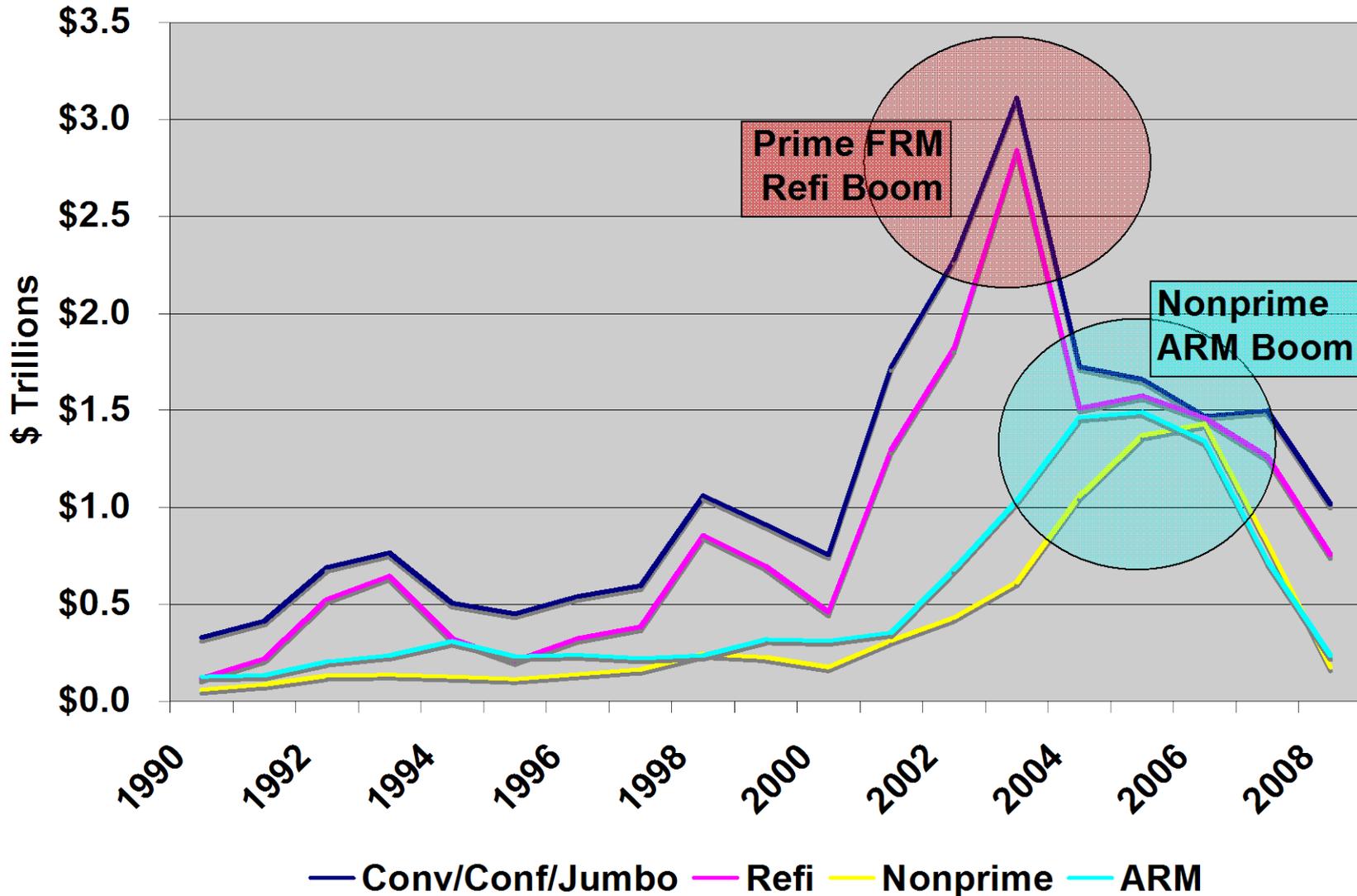
- Investors in securitized assets are at an informational disadvantage
 - the “Lemons” problem
- GSE securitization fixed the lemons problem by removing credit risk.
 - GSEs took credit risk on mortgages
 - Investors took interest rate risk and GSE credit risk
 - But GSE securitization was only possible because of implicit government guarantee.
- Private label securitization moved credit risk to investors.
 - Credit enhancements shifted most credit risk to subordinated tranches; 90% of PLS were AAA-rated.



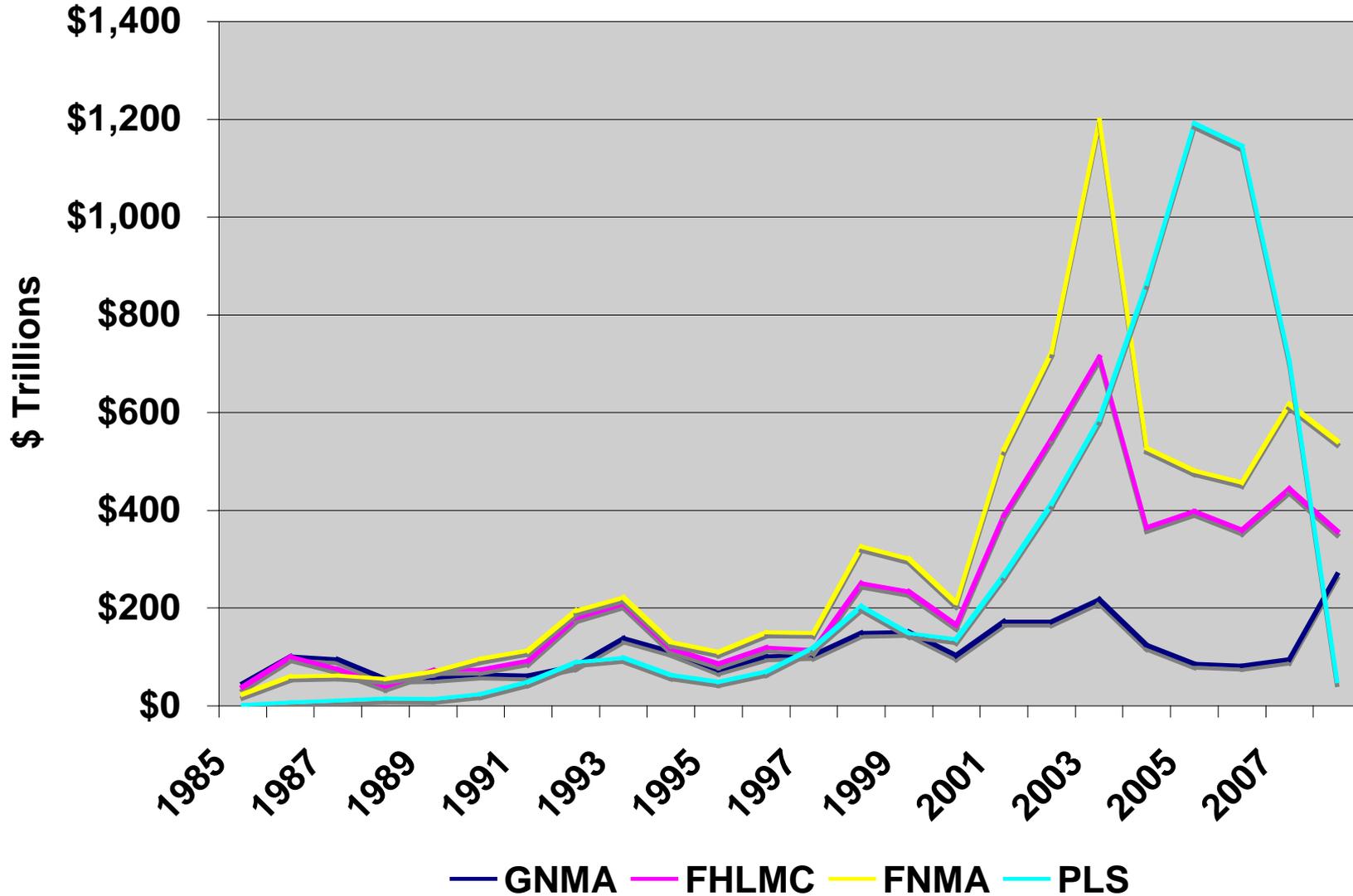
The Problem with PLS

- PLS are heterogeneous and complex
 - Heterogeneous and complex underlying mortgages
 - Heterogeneous and complex credit enhancements
- This means it is hard to price risk on PLS.
 - Credit ratings were poor proxy for risk.
 - Ability to resecuritize negated natural limit on risk appetite of more sophisticated subordinated securities buyers.
- And PLS were intended for inherently riskier, nonprime mortgages!
- Result was that PLS market fostered excess investor demand for MBS.

A Tale of Two Booms



MBS Issuance Volume



Source: Inside Mortgage Finance

Fixing Informational Problems

- Disclosure alone is insufficient
 - Product heterogeneity and complexity undermine consumer/investor analysis
- Standardization of MBS corrects heterogeneity and complexity problems
- Standardization of MBS requires standardization of mortgages eligible for securitization

Proposal: Regulated Securitization

- Permit only well-seasoned, standardized products to be securitized
 - Plain vanilla
 - 30-year FRM
 - Or “Neapolitan”
 - 15y and 30y FRM
 - standard 5/1 and 7/1ARMs
- Other niche products can be originated
 - But must remain on originators’ books; cannot be sold into capital markets