Q&A...

with Ronel Elul, a senior economic advisor and economist here at the Philadelphia Fed.

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Senior economic advisor and economist Ronel Elul joined the Philadelphia Fed in 2003 after teaching at Brown, New York University, and the University of Pennsylvania. He has also been a member of the Federal Reserve System's Model Oversight Group, which oversees the development and applications of the models used for stress tests required under the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act. As a researcher, he's long been particularly interested in household finance, especially mortgages.

When did you first become interested in mortgage markets?

Not until grad school. I was studying math in college, but I felt that economics was more practical and helpful for society, so I went to graduate school to study economics. At Yale, I took a class with John Geanakoplos on incomplete markets, which has to do with how we can't insure ourselves against all risks, like the risk that we'll lose our job. When he became head of fixed income research at a Wall Street investment bank, I went there part time for a summer. That's when I really became interested in mortgages. It was the early 1990s, and there was a boom in mortgage-backed securities.

After your stint on Wall Street, you wrote an article for the *Journal of Economic Theory* where you argued that new financial products have the potential in certain cases to make everyone worse off. Were you thinking about mortgage-backed securities when you wrote that article?

I wish I had. What I did notice while writing that paper was that these markets are volatile. That was intriguing but scary. Mortgage-backed securities, because they allow banks or the GSEs [government-sponsored enterprises] to easily sell the mortgages that they make, allow for scaling up of the mortgage market very quickly, and they make the markets less subject to the constraints that banks face. But they also make the mortgage market subject to the whims of the financial market. And that's something we saw in both the housing bubble and the subsequent financial crisis.

That 1995 paper was fairly technical. It wasn't until later that I got interested in real-life aspects like defaults. If we didn't have the protection of bankruptcy, people might be too frightened to take out a mortgage. Bankruptcy gives you an ad hoc way to tailor financial markets, to make them more complete. Then I started to wonder, what information is conveyed to markets when someone defaults? When the financial crisis hit, we were just starting to get the data to help us understand why people were defaulting on their mortgages, and what policies might help us address defaults. But that wasn't the kind of research I could have done in 1995. The data wasn't available yet.

It sounds like your experiences with Wall Street made you wary of what was going on there but also more interested in the real-world effects of financial markets.

Yes. Now I do a lot of regulatory work, helping oversee the models for the Dodd-Frank bank stress tests. Models are important, as they help us use historical experience to inform our assessment of future risk. But COVID was so different, we had to adjust how we use some of those models. To give one example, there were disparities in how various lenders reported the status of loans in forbearance for borrowers who were not making payments. And of course, we know that in times like this there are inevitably questions about how risky such borrowers really are.

Some people would say, well, given such uncertainty, why use models at all? But with a financial system as complex as the one in the U.S., the alternative would be to just make things up. We need to understand the assumptions and limitations of the models, and then think about how to deal with them. Seeing this in practice really does help inform your research.

What are some of the things you hope to learn from your research?

How to make certain that models continue to capture the risks in the financial system as it evolves. During COVID, Congress said, let's not report people in forbearance as being delinquent, because we don't want to discourage them from taking forbearance, and perhaps also because we don't want their decisions constraining the recovery. But the people who receive forbearance are probably riskier than people who continue to pay, and we don't learn that if we suppress that information. So, we're throwing away information when we do this. We've never done that, so we don't know who's going to be helped or hurt by it. And we also don't know how the market is going to react. That's something I've begun studying.