Information Failures in the U.S. Mortgage Market

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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

Source: Inside Mortgage Finance
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