Reforming the Housing Finance System
Rethink, Recover, Rebuild: Reinventing Older Communities
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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.