“CREDIT RISK TRANSFER AND THE SUSTAINABILITY OF HOUSING FINANCE”

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WRITTEN TESTIMONY
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Chairman Sean Duffy, Ranking Waters, and other distinguished members of the Subcommittee:

Thank you for the invitation to testify at today's hearing on "sustainable housing finance: private sector perspectives on housing finance reform." I am the Sussman Professor of Real Estate and Professor of Finance at The Wharton School of the University of Pennsylvania. Together with co-authors, I have researched and written scholarly papers on the stability of the housing finance system. Recent papers from which this testimony is drawn are listed at the end of this statement, It is an honor to be here today to discuss the future of the housing finance system and the role of credit risk transfers in helping to assure a stable and sustainable housing finance system going forward.

The housing finance system failed borrowers and taxpayers and it is important to understand why. We know now but did not know in real time the shift toward unsound lending. The bubble in housing prices that the expansion of unsound credit enabled masked the increase in credit risk. The failure to identify credit and systemic risk must be corrected going forward. Credit risk transfer programs if properly structured can help.

The global financial crisis began a decade ago with the Panic of 2007. Prior to this, credit markets' pricing gave no indication of increased risk. Rising house prices censored the underlying credit risk. Housing markets are prone to bubbles. Optimistic buyers, subject to "bubble thinking," determine real estate prices, even if prices exceed fundamental values, as long as they can access credit. Unlike in other asset markets, in housing markets, short-sellers cannot counter optimist buyers. In this way housing markets are incomplete.

Securities trading, however, can discourage excessive borrowing if credit risk is priced accurately and in this way counter housing bubbles. Securitization markets,

including the over the counter market for residential mortgage backed securities, however, failed at this in the run-up to the crisis. Mortgage backed securities did not trade and a lack of information on credit conditions misinformed markets.

Beginning in 2013, under the direction of FHFA, the GSEs have developed Credit Risk Transfers (CRTs) to share and trade credit risk. How CRTs are structured matters greatly to their potential role in reducing endogenous systemic risk. In addition, the eventual reform of the housing finance system will influence how well the CRT markets work or even whether the market can work at all.

What is necessary for the structuring of Credit Risk Transfers, and, more generally, for the restructuring of the GSEs to enable the CRT market to inform on credit risk going forward?

A first requirement is the direct linkage of CRTs' performance to the risk of the default of the underlying mortgages, with credit losses born by CRTs, tied to specific portfolios of GSE loans whose characteristics are known, tracked and available to investors, an important contrast from the earlier MBS. In addition, the use of a reference pool, allows the so-called TBA market to trade and price efficiently interest rate risk.

A second requirement, to avoid the pitfalls of the past mispricing of credit risk, is transparency and standardization to allow the identification of aggregate credit risk. The full provision of information on the mortgages in the GSE portfolios referenced by CRTs does this (along with information on portfolio lending and other sources of mortgage finance).

Third, to avoid counterparty risk, credit risk transfers must be structured so that the in the event of losses, funds are transferred automatically, This is achieved, in so called back end credit risk transfers, by writing down the outstanding principal balance of

the CRT securities, thereby reducing the amount that the GSEs are obligated to repay to holders of CRT securities, thereby offsetting credit losses on the related loans. The GSEs reduce the amount they pay on the CRT securities by the amount of losses on the loans so there is no counterparty risk for the credit risk transfer, as there would be in an insurance or reinsurance transaction for a third party. Counterparty risk is eliminated in the structuring of the so-called back-end credit risk transfer program.

Fourth, there needs to be trading of the credit risk instruments with open pricing in liquid markets, unlike in the crisis, where credit risk instruments traded over the counter. This too is in place.

Currently CRTs provide information on how markets price credit risk without mandatory linking of g fees to CRT pricing and without mandating the level of use of CRTs by the GSEs. Both are important to market stability. .

While the performance of CRTs should be linked the underlying performance of mortgages in the reference pool, as it currently is in back-end credit risk transfers, the pricing of CRTs should not determine g fees or mortgage interest rates.

While it is important to take into account market information in a build up to a crisis, in a crisis period, in a period of market stress, investors in CRTs are likely to pull back; if so, nothing would prevent the collapse of housing credit and the follow on implosion of housing prices. The discretionary setting of G fees over the cycle is necessary to limit pro-cyclicality and avoid reintroducing market instability. (G fees, or guarantee fees, is the fee retained by the GSEs from the payments received on mortgages as compensation for guaranteeing the timely payment of principle and interest on the MBS that Fannie and Freddie issue). For the same reason, the use of CRT should not be mandated—that is, it should be discretionary. Mandatory risk sharing is an inefficient policy as it encourages transactions where the cost of the risk transfer is greater than the cost of the GSE retaining the risk and thereby raised the cost of mortgage lending.

Currently the trading of CRTs provides information about what private capital markets would charge for the credit risk generated by the credit guarantee business of the GSEs (as well as sharing that risk) but is not automatically linked to G fees. The G fee is set administratively, with significant guidance from the FHFA and CRT does not directly impact the setting of g fees or mortgage rates. This should not change.

The structure of the housing finance system itself is important to the functioning of credit risk transfer markets. If there are many guarantors or credit enhancers, each with its own CRT market, such markets will not be liquid. Moreover, with many entities each setting its own standards and its own pricing or g fees, even with the guidance of FHFA, there would be a tendency to compete over these standards and undermine them over time; nor would the pricing and this risk this entailed be fully reflected in the pricing of that firms' CRTs as this would raise prices throughout the market, and impact market risk accordingly. Similarly, CRTs are not a substitute for equity capital, that is, internal capital that the regulator can require for the long run.

The pricing of housing finance should be set over the cycle and standards should be maintained over the cycle as well to limit risk and to provide sustainable housing finance for the long term.

I thank you for the opportunity to testify today and I welcome your questions.

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