Brooklyn Law School

From the Selected Works of David J Reiss

Spring 2014

The Future of Fannie and Freddie

David J Reiss, Brooklyn Law School

Available at: https://works.bepress.com/david_reiss/79/
PANEL FOUR:
THE FUTURE OF FANNIE AND FREDDIE

Panelists: Mark Calabria, David Reiss, Lawrence White, Mark Willis
Moderator: Michael Levine

Professor Michael Levine: So we have been struggling in the thickets and brambles created by the 2008 crisis. This panel is going to take us out into the open, but I’m going to suggest that the open turns out to be a fairly large swamp. So since we have a large swamp, we happen to have a superb panel to help us figure out where we’re trying to go, and what some ways out of it might be, and whether anyone thinks we can get there, and what happens if we don’t. I’m going to introduce all the panel at once, rather than do the shtick each time they get up to speak.

Larry White holds a chair at this turn school, at least as important for this discussion. He’s a former member of the Federal Home Loan Bank Board, and a member of the Board of Directors of Freddie Mac, but I will say, before it became disreputable.

Professor Lawrence White: Thank you, thank you, Michael.

Professor Levine: David Reiss, David Reiss is a Professor of Brooklyn Law School, have written extensively, some might say, at numbing length on mortgage finance and housing development.

Professor David Reiss: Many would say that, actually.

Professor Levine: On mortgage financing and housing development, and knows a great deal about it. Mark Calabria is Director of Financial Regulation Studies at the Cato Institute. He was previously deep in the swamp as a senior staffer at the Senate Committee on Banking, Housing, and Development, and also a deputy assistant secretary at HUD. And Mark Willis, who is currently here at the Furman Center at NYU, spent 19 years at J.P. Morgan Chase working on community development issues, before that, was a deputy commission in the New York City government, and at the Federal Reserve Bank of New York.
So let’s start with Larry, to give us an overview of where we might be trying to get as we try and wade our way through the swamp.

PROFESSOR WHITE: Thank you, Michael. First, at the Federal Home Loan Bank Board, Chuck, I did many of those deals that you talked about that were subsequently litigated. Next, Michael mentioned that I was on the board of Freddie Mac. When I left government—I was there as part of my government service, and when I left government service, I left the board. Subsequently, in 1998, Freddie Mac asked me to write an article for their publication, Secondary Mortgage Markets, and paid me $5,000 to do so. It was published in 1998. It’s available through a link on my resume, which is available on my website. I’m very happy with that article; it said all the right things.

[Laughter]

In 2004, Fannie Mae asked me to come in during the summer of 2004, to Wisconsin Avenue, and give a presentation to their Advisory Board on the BASEL capital standards, bank standards. I agreed to do so. They paid me $2,000 plus travel expenses. I flew coach class to and from LaGuardia and National Airport. I took street-hail taxi cabs to and from the airports. Full disclosure.

[Laughter]

All right. Now, I also have to indulge in a little bit of shameless self-promotion. This is the book, Guaranteed to Fail. Until Peter brings his book out, it’s the book on Fannie Mae and Freddie Mac, and last thing I have to say is, here in this Law School, I’m not a lawyer. I do not practice law without a license.

All right, Michael said that we’ve been down in the bushes, the brambles, and I’m going to take us a little bit higher. I don’t think 30,000 feet is a good altitude, but maybe 300 feet, to be thinking about larger issues, and what are those larger issues? First, thinking about housing policy in the United States. First, there is the idea, we do have housing policy. I don’t know whether it’s dozens, but certainly lots of lobbying groups, interest groups, who describe themselves as housers. You’ve certainly heard that phrase many times, Mark, housers.

DR. MARK CALABRIA: I’m taking offense already.
PROFESSOR WHITE: Housers, all right, and we don’t have groups calling them the—

DR. CALABRIA: Tires.

PROFESSOR WHITE: The tires, or the window treatmenters, but there are housers. Now, why is that so? Well, it’s because housing turns out to be a large fraction of typical household budgets, even more so for lower income households, and so if you can get some subsidy for housing, you may be able to do something for low income households. In addition, where do households spend a big chunk of their hours of the 168 hours in a week? In the house, so that’s the environment, if you can do something for that environment, gee, maybe you can improve things, so I think, just from a political economy perspective, why are we here, why is there this conference, why is there housing policy and not necktie policy or window treatment policy? Because housing is so important.

In fact, it is heavily subsidized. Fannie and Freddie have been part of that subsidy, but it goes much farther, of course. We’ve got income tax subsidies, the mortgage deduction, the mortgage interest deduction being the most important piece, also state and local taxes. We’ve got FHA, of course, and Ginnie, we’ve got the Federal Home Loan Bank System, we’ve got state and local policies as well. Housing is generally subsidized.

One of the consequences of that subsidy is that people buy more house, and they occupy more house. A former colleague of mine Ed Mills, who once made what looked to me like pretty good estimates, that the housing stock is 30% larger than it otherwise would be, which means the GDP is 10% larger than it otherwise would be because of all the subsidies, because we’ve consumed more resources in housing and less in other things, and that is investment that could have gone somewhere else, and whether you think it’s for social capital, roads, hospitals, airports, schools, whether you think it’s for private sector capital, more factories, plant equipment, inventories, whether you think it’s human capital, better education, better training, it could have gone somewhere else. Instead, it has gotten sucked into housing. And in fact, especially with the income tax subsidy, that’s mostly enjoyed by upper income households, because they’re the ones that find it worthwhile to take the deduction, specific itemized deduction, rather than
taking the standard deduction, in addition, because they’re more likely to buy a bigger house. That means they’ll be taking a bigger deduction. All of that works towards the favoritism for higher income households who would very likely buy anyway, and so all you’re ending up doing is encouraging them to buy a bigger structure on a larger piece of land, five bedrooms rather than four, four bathrooms rather than three, half an acre rather than a third of an acre. Where is the social gain in all of that?

As it turns out, it doesn’t look like we’ve really changed home ownership rates all that much. I would argue, we shouldn’t be paying as much attention to home ownership rates as we’ve done in the past. Yes, there is a moderate social gain to someone being a household, being a homeowner rather than a renter. It is there, I believe it, but that calls for a much more targeted, on-budget program, aiming toward the household that’s on the cusp, that might rent, might buy, encourage them to buy, targeted, transparent, on-budget, rather than this very broad, scattergun effect.

We’ve been talking about Fannie and Freddie, and they’re going down—that’s a technical term in economics, going down the toilet—so I’m not going to spend any time there. Over the long run, what should be the policies? Reduce the overall subsidy for housing. What remains should be much better targeted, much better focused.

Focus on that first-time home buyer, and try to get away from subsidizing the lending, subsidizing the borrowing, encouraging the low down payment, because what does that do? That encourages greater leverage, means the household has—leverage works at all levels, and to the extent that a household is more leveraged, the household has less skin in the game in terms of preserving its stake in the house, and is more ready to walk away with all the consequences that follow through from default.

We ought to be winding down Fannie and Freddie. We shouldn’t be replacing them. The FHA should be more transparent and more focused, hopefully getting away from the lending/borrowing subsidy.

In addition, to prevent future debacles that might be triggered from the collapse of some future bubble, we need to
make sure that depository institutions and other large, systemic institutions, are better capitalized. The real problem was nine very large financial institutions that didn’t have access to deposit insurance and didn’t have access to the Fed, were way too thinly capitalized, could not absorb the losses. Fannie and Freddie were two of those nine and could not absorb the losses from the collapse of the housing boom. Better capitalized, better liquidity requirements, limitations on their activities, orderly liquidation authority for sure, and a good, adequate number of well-trained, well-paid individuals as examiners and supervisors for that effort.

There will be mortgage lending, and I truly believe there will be a 30-year fixed-rate mortgage. It won’t be quite as cheap as in the past, because the subsidy element won’t be there. The jumbo market does provide these things. I think it can operate more generally to get the securitization process back on where clearly, we will have simpler structures. We do need to get the qualified residential mortgage rules finalized, so there can be certainty out there among securitizers as to what’s expected of us. I would like to see a better story about down payments, but at least let’s just get some final rules out there, so the securitizers know what to expect and can go forward.

Natural buyers of this kind of paper are the life insurance companies and pension funds who have long-lived liabilities, and ought to be looking for long-lived assets. They invest some now. You don’t want them investing entirely, all of their portfolios, of course, you want them to have diversified portfolios, but it seems like they’ve got five percent of their portfolios in this natural long-lived security, and you would think it would be natural for them to have more.

We have also got to do something about pre-payment fees because I think the absence of pre-option fees, the free option of pre-payment on the part of borrowers, is at least part of why they are being deterred, and this is an option—it’s a valuable option. The borrower ought to be paying directly for the option with pre-payment fees.

Over the yet longer run, recourse ought to be the norm, so that a borrower knows, I can’t just walk away, and nobody is ever going to come after my other assets. This will deter strategic defaults, and get people more conscious of the risks of leverage. We need to let the primary lender have a veto power
over any second lien that a borrower wants to take out. This is absolutely standard in commercial lending. It ought to be the norm in residential lending as well.

In addition, over the long run, if we really want to do something about the cost of housing, let’s look at the real resource issues like: we have limitations on lumber coming in from Canada that keeps the price of lumber and the price of houses more—keeps them higher than would otherwise be the case; we have limitations on cement coming in; we have limitations on cement coming in. It used to be very explicit with Mexico. We still have anti-dumping restrictions on cement coming in, and that keeps the cost of housing more costly. We have inefficient local building codes, and zoning restrictions that keep the cost of land, especially for multi-family, higher than would otherwise be the case. And the final thing is getting away from the idea that home ownership is this overwhelming goal—no, it’s right for some households, it’s not right for others. It’s a big, illiquid asset, it’s costly to buy, costly to sell, it reduces labor mobility, make renting more respectable. There it is.

[Applause]

PROFESSOR LEVINE: It all makes such good sense, Larry, that I found myself wondering just in which state you were planning to run for election on.

PROFESSOR WHITE: Thank you, Mike.

PROFESSOR LEVINE: David?

PROFESSOR REISS: I prefer to stand, so if Larry gave us a view from 300 feet, I think I’m going up to about a thousand feet, so let’s see how that goes. So, the issues that we’re struggling with regarding housing finance policy today, I think are comparable to the issues that we struggled with during the early years of the Great Depression. Unfortunately, I feel that housing experts in the ’30s had a greater clarity of purpose in designing their housing finance system than we do today.

I’d like to spend some time thinking about fundamentals, because I think part of the problem today is that housing finance waters have been muddied, I guess that’s the swamp that we’re in, by broader ideological battles, entrenched special interests, as well as plain old inertia and fear of change. So, what should the infrastructure of housing finance look like? And whatever we decide will shape, in all likelihood,
housing finance in this country for generations: for 30, 40, 50, 75 years.

So, to help answer that question, let me provide a little bit of context about American housing policy. I’ll then give an overview of the approaches that we can take with Fannie and Freddie after they exit conservatorship or are replaced by some other entities, and I’m going to conclude by highlighting some hot button housing finance issues that must be addressed before we can move forward with a coherent plan of reform for the housing finance system.

These issues are frequently trotted out to support the status quo, but they’re not really the roadblocks that people portray them to be. These additional issues include: first, what is the future of the 30-year mortgage; second, what’s the fate of the lock-in, whereby a person can get a guaranteed interest rate before they actually close on the loan; third, what’s the fate of the low down-payment mortgage; and finally, how much will we allow the goal of increasing home ownership to impact the design of our housing finance system? The answers to these questions reflect deeply held views about what home ownership means in our country.

So, let’s start with the context. As Larry indicated, the federal government has a bewildering array of housing programs. He ran through them. He also mentioned the housing expenditures that we have, such as the deduction for mortgage interest on a primary residence. There’s also the capital gains exclusion, the deduction for property taxes, a whole spate of tax expenditures that subsidize housing as well. And then, the housing finance infrastructure is also incredibly heavily regulated by an unbelievable web of entities, including the FHFA, including HUD, including the newly created CFPB, but then also the Federal Reserve, the FDIC, OCC, and the SEC all play a role in it as well.

So, trying to derive a clear understanding of federal housing policy in the face of such extraordinary complexity is no mean task, but I’m going to do it in the next ten minutes anyway. So let me move on to my second point.

I want to talk about broad ethics, things that inform how we talk about housing policy, and three that I think are applicable today are first, housing as just a plain old economic
good, second is housing as a human right, and third, housing as a bulwark of democracy.

The housing-as-an-economic-good ethic treats housing as any other commodity, and asks how government policies will distort the functioning of the market for housing. This ethic, housing as an economic good, is woven into our debates about housing policy, because we’ve seen so many examples of policies having unintended consequences. So rent control, for instance, that’s to help tenants. Well, if it reduces the supply of housing because people can’t make a profit by building housing, that’s an unintended consequence, and so we’re always careful in our discussions about housing policy to look for those unintended distortions.

The second ethic, housing as a human right, asks how a policy furthers the goal of making affordable housing available to all, and the last, the housing as a bulwark of democracy, reaches back at least as far as the time of Thomas Jefferson to the idea of the yeoman farmer who owns his homestead, is financially self-sufficient, and acts the part of a democratic citizen. This ethic is central to our vision of ourselves as a country.

So let me move on to a further point: what should be the aim of housing policy? In other words, what can a well-designed and executed housing policy achieve? So, echoing the housing ethics outlined above, some assert that the main aim of housing finance policy is to assist Americans to live in safe, well-maintained and affordable housing. Another might have a more modest expectation; housing finance as a specialized form of income redistribution that ensures that the income transfer is consumed in increased housing. And finally, some argue that home ownership and stable housing is fundamental to our notion of citizenship, and that we should encourage it for that reason and that reason alone, and the importance of this to American housing policy cannot be overstated. It reaches back to Jefferson, but continues on to Lincoln’s Homestead Act of 1862, and in the twentieth century, the yeoman farmer of Jefferson’s day morphed into the home owner that was central to the platforms of presidents as varied as Herbert Hoover, Linden Johnson, Bill Clinton, and George W. Bush, who all made home ownership a key aspect of their political agendas, and certainly, in the response to the crisis of both Bush and Obama, we’ve seen the extraordinary lengths
that they have gone to try to reduce the foreclosures and somehow stabilize the housing markets.

While these principles that I outlined, these three kind of ethics, are kind of goods in themselves, policies that we're trying to achieve, the housing finance industry is also governed by lots of auxiliary principles. Really, these just relate to the size and importance of the housing industry to the American economy. And so for instance, during the crisis, finance industry representatives argued for policies that stabilized the mortgage markets, also noting the impact that the mortgage industry had on the health and stability of the overall economy. And clearly, many of the policies, short-term policies that we've implemented since the crisis, reflect that desire to just stabilize that part of the economy.

Let me move on to my second point to demonstrate just how confused our approach to housing policy can be, and how far it can veer from what I'm calling these more legitimate principles around which we can design a housing policy. This would be the case study of Fannie and Freddie.

Let's keep in mind, as one of the earlier panelists said, that the initial reason for state support of Fannie and Freddie, which was to create a national residential secondary mortgage market, has been achieved. It did require federal action; there were various federal rules and variations among the states that did not allow a federal—a national market to exist, but Fannie and Freddie have since done that. So their exit plan from conservatorship should not be about continuing from those past needs, but they should look at our contemporary needs. Fannie's slogan is, "Our business is the American dream," and Freddie's is, "We make home possible." Taken together, these two company slogans reflect their claim that they're acting in accordance with the ethics of housing as a bulwark of democracy, the American dream, and housing as a human right. It is true that they do reduce the cost of mortgage finance a tiny bit, as other panelists have mentions, but we have seen, in the run-up to the crisis, that the interests of management and shareholders overwhelm that public benefit, as the companies took great financial risks with management and shareholders getting the upside of the risk, and taxpayers getting the downside.
A careful review of their activities demonstrates that they’re having a modest impact on achieving those goals, and in fact, if one were to properly identify the principles upon which the contemporary Fannie and Freddie have been operating, it would really relate to those auxiliary principles relating to the operation of the housing market itself, so Fannie and Freddie just became tools of the housing market infrastructure, and we should not give any deference to them, other than to see them as tools.

So, how should we determine the future, post-Fannie and Freddie? Obviously, lots of people are proposing answers to that. The Obama Administration had considered a broad swath of options two years ago, when it released its white paper. We’re seeing the Corker-Warner Bill and all the proposals from various think tanks. How can we think about all these proposals as we gear up to actually implementing the next iteration of housing finance in this country?

I would say we could categorize roughly in three ways the ways that we can go with Fannie and Freddie. First, Fannie and Freddie generally did the job that they were designed to do, give or take a crisis here and there and their successors should continue to do much the same. Second, Fannie and Freddie should be nationalized, because the federal government has taken on most of the risk associated with them anyway. And finally, Fannie and Freddie pose a systemic risk to the financial system, unfairly benefited from the regulatory privilege, did not create net benefits of any significance for the American people, and as a result, they should be privatized.

One taking the first view that Fannie and Freddie generally do the job that they’re supposed to might argue that industrialized nations have effectively, in one way or the other, tightly regulated and are tightly connected to housing finance. And America is no different than what you might see in Western Europe in terms of the close relationship between housing finance and the government. Therefore, there’s no obvious need to extricate the federal government from its relationship with the housing finance system, and we might have some modest reforms. Examples could include limiting the government guarantee just to the mortgage-backed securities themselves, not to the companies that issue the mortgage-backed securities, creating a number of smaller and Fannie and Freddies, so that you have competition, like you do with regulated
banks, and that would hopefully have some positive impact on “too big to fail.” They could be regulated like utilities, and then all would be good. And then finally, we’ve heard today about the notion of requiring financial institutions to take a first loss position of some percentage, and that would put skin in the game for the people originating the mortgages.

The second position, nationalization, has only gotten to be taken seriously since the Fannie and Freddie bailouts, and even Secretary Paulson considered it in the early days of the crisis. This could be done by merging Fannie and Freddie with the FHA, or by creating an alternative that focuses on a different segment of the market. But again, we would want to be very concerned about putting all of that underwriting in the hands of the government. The government has not historically underwritten things like this all that well, not that the private sector has done either, but the taxpayer will be on the hook for poor underwriting by a government agency. In fact, right now we’re dealing with a nationalized Fannie and Freddie. The Obama Administration effectively treats it as such right now.

The third view is that Fannie and Freddie pose a systemic risk to the financial system—and I’ve looked at this carefully in an earlier article, I won’t go into the details—but effectively, I think the strong case, and I think many people in this room would agree, is that they have not lived up to what they claim to be able to do, and there’s no argument to have these hybrid entities. And there is an argument that the private sector should actually bear the risks of housing finance.

I’d like to turn away from this notion of how do we transition from where we were to the future, and rather to ask another question. If we created from scratch a housing finance industry and infrastructure for the nation, what would it look like? I don’t think having everything centralized in the duopoly of Fannie and Freddie or companies like that would be the solution we’d look for. Privatization, letting the private financial institutions address this issue, I think is a better alternative, but obviously that privatization would need to be complemented by a lender of last resort to step in during financial crises. That lender of last resort could be a revamped FHA, although I know a lot of people would have issues with that. It could also be an FHA-like entity, which could be created for that purpose.
We would also need to support vibrant consumer protection, because Fannie and Freddie did implement standards in the industry that were good for consumers. They also standardized the industry in many ways, which were good for consumers and industry participants, but we have the agencies in place that can do that as well. The CFEP can take the lead on consumer protection, and the Fed, HUD, FDIC, FHFA, OCC, and SEC can work in tandem, or authority could be given to some subset of them to provide more standardized rules and regulations for the secondary market.

Moving from the theoretical to the political, obviously there is not going to be an ideologically pure solution to this question in Congress. There will likely be a compromise between the status quo and privatization. That seems to be where we’re going, but I still think it’s important to identify what we are trying to achieve instead of just muddling along. Putting aside liquidity crises, where there is near universal agreement for a federal lender of last resort, and putting aside special supports for low and moderate income families, for which there’s also broad support, what role do we want the federal government to play in the rest of the market, and shouldn’t we let private capital take on as much of the credit risk as it possibly can before we bring in government support, before we claim that there’s a market failure requiring government intervention? I would say we don’t want to subsidize housing for the middle and upper middle class, and we don’t want to distort the housing market with those subsidies, which puts me very much in line, I think with Larry’s comments as well.

So, let me move on to my final topic in the few minutes I have left, let me talk about those hot button issues that are frequently muddying up the waters as we talk about housing finance reform. The 30-year mortgage, the lock-in, the low down payment mortgage, and the goal of increasing home ownership: each of these is presented as a reason why we need to have an active government role in the massive middle of the mortgage market that serves most Americans.

First, what will the future of the 30-year mortgage be? My best bet is that in any reform plan, it will be safe and sound one way or the other, but I certainly question America’s kneejerk support of that mortgage product. First of all, the private jumbo market has demonstrated that there is at least some investor interest in a 30-year fixed rate mortgage without
a government guarantee. And more importantly, American families live in their home for seven or so years on average, which implies that a shorter fixed term is in their best interest. They’re not going to pay excess interest to buy a product that they don’t need.

Now of course this is not to say that we want ARMs with short-term fixed periods, like one-year ARMs, two-year ARMs, three-year ARMs, but seven and ten-year ARMs would address the needs of most households, and it is to say that innovation is welcome in the notion of fixed rate mortgages. My own sense is that households are more concerned about interest rate stability because of the potential of payment shock when interest rates skyrocket. I would be interested to see innovation along a variety of axes, including longer fixed periods. Ten years might cover most households.

Interest rates based on rolling averages that slowly change the rate of interest, longer adjustment periods between interest rates, such as three years, or five years. Lower annual caps on interest rate increases, perhaps one percent instead of the more common two percent. All of these suggestions could reduce payment shock and still allow lenders to move away from the 30-year fixed rate mortgage that works so poorly when you borrow short and lend long.

Regarding the fate of the lock-in, Fannie and Freddie have developed a system that provides consumers with more certainty as to their interest rate prior to actually closing on their loan. Can it be kept? I think there are some regulatory changes that would need to be made to allow an alternative to the Fannie and Freddie TBA market, but I don’t see any reason in principle why we couldn’t do that, or why we couldn’t come up with a solution. The fate of the low down payment mortgage, from an underwriting perspective, 20% is clearly desirable. From an opportunity perspective, a 20% down payment requirement would keep large swaths of potential first-time homeowners from taking the plunge. The proposed QRM rule-making is leaving this up in the air for now, and this will require ongoing attention. But there is a possibility that either the private mortgage insurer market can play a role here in closing that opportunity gap, or we may need further government intervention along the lines of the FHA.
And then finally, the appropriateness of unthinkingly increasing home ownership. A broad swath of thought leaders on the right and left have pushed on this and reminded us that rental housing can be the best option for many households, and there is a lot of pushback on this, because home ownership is, after all, our American dream. But let me leave you not with a thought, but with an attitude. Too much of the debate about our housing finance system is driven by fear of change, often expressed as concerns about the transition from our current system to what comes next, so I submit a proposal.

Let us make clear what we want from our new system, and then design it, and design the transition to get there. If we don’t, we will accept a hodgepodge of programs and policies that look familiar, but don’t do what we want them to do. I look forward to your comments and questions.

Professor Levine: Mark Calabria.

Dr. Calabria: Well, to follow up on Larry’s disclosure, I guess I should also mention, I’m an economist, not a lawyer. Despite being an economist, however, during my time as staff on the Banking Committee, they did occasionally let me draft pages of legislation. Given that I was one of the two primary staffers who drafted the conservatorship and receivership language, there’s not a lot of legislative history behind it in the hearings, but I can certainly say that none of it worked out the way we intended.

[Laughter]

With that said, whereas Larry was up here and David was up here, I’m going to take a very narrow, deep dive on a topic which Larry mentioned briefly, which is the topic of leverage. I’m going to talk about capital standards: how they work at Fannie and Freddie, and in particular, I’m going to talk a little bit during my remarks about how the capital standards at Fannie and Freddie interact with capital standards of the rest of the financial system, such as the BASEL Capital Accords.

A theme to keep in mind, I think, is of our mortgage finance system as a house of cards, and you have to be very, very careful when you pull out one card, how the rest of them are going to play out. I’ll also mention, before we get started, that Fannie and Freddie had, to me, the very unusual benefit that their minimum capital standards were actually codified in statute. The bank regulators determined, essentially, what bank
regulations look like. The BASEL Capital Accord, whether this is a good thing or a bad thing, are not written by legislators. They’re written by regulators. Congress, in the 1992 Act, decided, for instance, that Fannie and Freddie’s on balance sheet exposures would have 250 basis points of capital, and decided that their off balance sheet exposures would have 45 basis points of capital. Personally, I think that’s really all you need to know about Fannie and Freddie. Off balance sheet exposures were leveraged over 200 to 1. That’s a recipe for a disaster, no matter what else you do, and that was mandated by statute.

I will note that in 2008, in the Housing Economic Recovery Act, we did give FHFA the flexibility to, by regulation, go above that. Now, obviously, HERA was passed in July, the entities were taken into conservatorship in September, so there never really was a repromulgation of the minimum capital standards. I think if Fannie/Freddie do enter the market again, what their capital looks like is going to have to be a very important part of that.

I’ll also note, as an aside, a part of legislative history: in 2004-2005, initial attempts—or I should say, there were certainly attempts before that, but my initial attempts—as part of the process to reform Fannie and Freddie, minimum capital standards were really one of the three or four things that absolutely was an obstacle to reform. And so while I can sit here and poke fun at being leveraged over to 200 to 1, the consensus in Congress in 2004 and 2005 was that that was appropriate, explicitly appropriate.

It’s also worth noting the 1992 Act establishes a system of risk-based capital standards for the GSEs. And despite the fact that their previous regulator took almost a decade to promulgate that rulemaking, those risk-based capital standards were never, ever binding, so were a decade of wasted effort in my opinion.

Also, to put some numbers to this for a little perspective, I am an economist. I have to put some numbers out there or it’s not quite complete. In 2007, which I think is before we started to see this erosion of Fannie and Freddie, Fannie’s core capital was 45 billion, and Freddie’s core capital was 38 billion. With little bit more than 80 billion capital between them, they were a $5-6 trillion footprint in the mortgage market, backed by
about 80 billion in capital. As a percent of assets and outstanding guarantee, Fannie’s core capital ratio was 1.5%. Freddie’s was 1.7. Again, massively leveraged institutions, regardless of what you look at it.

To put this in perspective, one of the claims I often hear is that, well, Fannie and Freddie weren’t so bad, because those bad subprime lenders had default rates that might be higher. Again, keep in mind that Fannie’s capital ratio was 1.5. The foreclosure rates on prime mortgages, forget the subprime, the foreclosure rate on prime mortgages held by Fannie and Freddie was three percent, and given a recovery rate of usually about 50%, Fannie and Freddie would have gone belly up solely on the basis, in my opinion, of the prime losses. So again, their leverage there, to me, was a recipe for disaster, and I think going forward, this minimum capital has to be part of the picture.

Now, again, as I mentioned earlier, this is part of a broader system, so I want to talk a little bit about how Fannie and Freddie interact with the BASEL Capital Accords that apply to banks, because it’s not only my contention that Fannie and Freddie themselves were highly leveraged, but that they drove a high amount of leverage in the rest of the financial system. Recall that the way BASEL works is, you have a risk weighting of capital, and so to give you some example, if a bank holds a home mortgage on its balance sheet, its risk weight is 50%, and so again, with our 8% minimum example, that gives you an actual capital of 1.6, which is obviously considerably below four. Again, my point being is that you have not only this high level of leverage on the part of Fannie and Freddie, but their existence and their interaction with the bank capital standards increased the leverage of banks as well.

Now, of course, you have to look at the system-wide impact of this, so let me walk you through how that would work. Let’s go back and say—and this was a commonality before the crisis—where Bank A would take a thousand mortgages, sell
those thousand mortgages to Fannie, Fannie would wrap those mortgages into an MBS and sell it back to Bank A. Now, of course, the reason for Bank A to do this is lowered capital standards, and of course, it leaves a credit risk for Fannie, and it reacquires the interest rate risk. I think there’s an important aside, because we often hear about the importance of the 30-year mortgage. In my opinion, what is special about the 30-year mortgage is the interest rate risk, and the interest rate risk flows to the ultimate investor in the MBS. Fannie and Freddie only absorb interest rate risk to the extent that they retain mortgages and MBS on their balance sheets.

So, what one needs to do to actually get a picture of system-wide risk is to take that capital for Fannie and Freddie and combine it with the capital for bank, so quite simply, we take our 1.6 from the bank, we take our 45 basis points, and that tells us that the system of securitization which Fannie and Freddie drove leads to a system-wide capital of 2.5%, which is again, considerably less than the four percent capital we had had these mortgages remained as whole loans in the balance sheet of depositaries. Again, my point is that the combination of the existence of Fannie and Freddie with the BASEL Capital Accords resulted in a 40% reduction of capital in our mortgage finance system.

To put this in perspective, my back-of-the-envelope calculation is that had all of the mortgages that Fannie and Freddie purchased instead remained on the balance sheet of depositaries, we would have had an additional $200 billion in capital in our financial system at the time of the financial crisis. Of course, we can ask whether that capital would have been forthcoming, but again, assuming that level of mortgages.

I think this also shows up, if you look at the ratio of risk-weighted assets to total assets for banks. We saw a considerable decline in that ratio from 2000 to 2006. Now, of course, the bank regulators look at this and say, well, banks must be safer, they’re holding a higher percentage of less risky assets. What it also tells you is that banks are increasingly leveraged during that time. So again, not surprisingly, this system drove a continued leverage in concentration. To give you some sense of one of the reasons that Fannie and Freddie had to be rescued, or I would argue, were rescued, was that much of the financial system was loaded with Fannie and Freddie debt.
If you looked at insured depositories, their holdings of Fannie and Freddie debt equaled 150 percent of their tier one capital. Quite frankly, if we had probably followed my path, or the path that was actually set out in here, or we had gone into receivership, we probably would have had an additionally large number of small institutions, and banks fail. As we know, a small number of institutions did fail in terms of when their preferred shares were wiped out, but again, this interconnectedness of Fannie and Freddie with the rest of the financial system was not an accident, but one of deliberate design.

I don’t have time to go into it today, but to me, one of the more interesting aspects that has received very little attention is that Fannie and Freddie securities were about a third of the collateral in the repo market. And you see, up until conservatorship, repo haircuts on Fannie and Freddie securities really blow out, so to me, that was another source of decreased liquidity. It’s also important to keep in mind, before the implementation of the first round of BASEL, the market share securitized mortgages are about 30%, so after the implementation of BASEL I, pre-BASEL II. Remember, we never fully implemented BASEL II here in the U.S.; you saw the share of the mortgage market double in terms of what was securitized, so again, my point is that the existence of Fannie and Freddie, the operation of Fannie and Freddie greatly interact with other regulatory measures on the bank side. Any sort of plan for a path forward has to not only look at Fannie and Freddie, but look at how Fannie and Freddie fit in with the rest of the system.

Since home ownership has been mentioned a couple of times, I’ll put a couple of numbers on that. I agree with Larry and David, although they might be actually more generous than I, so let me just quickly put the number out there. In 1936, our home ownership rate was 64%, at which the market share of the GSEs was in single digits, and home ownership today is very similar to that. My point would be that we’ve had the growth of a securitized mortgage market, we have the growth of Fannie and Freddie, and with almost no gain in long-term home ownership rates.

If one believes that one of the other objectives should be to lower the gap in home ownership rates between whites and African Americans, it’s worth noticing that at the height of the bubble in 2007, the home ownership rate for whites was 76.5,
while that for African Americans was 54%, leaving a gap of 22.5. In 1910, before the curation of FHA, Fannie, Freddie, that gap was 23.5. To me, that’s quite shocking. In 100 years, we have managed to close the racial home ownership gap by one point.

I will note that it actually did close for a considerable amount of time, up until 1980, which was before we had a very large secondary mortgage market. If you track the growth and market share of the secondary mortgage market, as a share of the mortgage market, it also parallels a growth in the home ownership racial gap, and of course, that shouldn’t be a surprise. Securitization focuses on cookie cutter, easy-to-securitize loans, so to the extent that any loans by minorities are harder to securitize, that will leave them behind. This point about the rationale for Fannie and Freddie, in my mind, is just not delivered.

There’s a couple of other things I want to note, that I think, to me, bring a little bit of interest in terms of how they go forward. As I mentioned, the guarantees previously had a capital of 45 basis points. One of the more interesting issues to me is, in conservatorship, our friends at FASB made some significant changes to the treatment of off balance sheet entities, which forced a consolidation. One of the potentialities going forward is that Fannie and Freddie might actually have to hold 250 basis points against off balance sheet liabilities, rather than 45 basis points, which is again, a pretty big change, but still less than the 400 basis points that banks have to hold.

I want to end with what I think is kind of an interesting legal curiosity to me, that actually does a little bit impact on the receivership debate. Section 1303 of the 1992 Act places some interesting limitations on what counts as capital. This is still in place. I’ll just read this limitation very quickly, which is, the core capital of an enterprise shall not include any amounts that the enterprise could be required to pay at the option of investors to retire capital instruments. There’s further language in the act that essentially makes pretty clear that the only thing that counts as core capital is capital that is perpetual.

Yet, here is Section 1117(c), which is where the authority for the Treasury’s preferred shares are injected. We find terms such as, temporary authority, limits on maturity, need for pref-
ferences or priorities, and repayment. It’s pretty clear to me that the intent here, and again, one of the people there at the table, was that any capital, any assistance would be temporary, which raises the question in my mind, how can any of it count as core capital if it’s temporary? I will note, interestingly enough, my friends at OMB seem to agree, that if you go back and look at the last couple of budget submissions, they are very clear that since conservatorship, Treasury considers the preferred shares to be temporary in nature, which of course, raises the question in my mind that they have no capital.

Under HERA, if you don’t have capital, you’re mandatorily in receivership. So, I would argue, if there’s any violation of the law going on, it’s FHFA’s ignorance of the statutory requirement to actually enter receivership, given their entities have no legal capital.

PROFESSOR LEVINE: Mark Willis.

DR. MARK WILLIS: Thank you. So, I want to compliment my other speakers here in making the case to phase out the government guarantee, at least beyond FHA. I just want to remind everyone, to set the context here, is that we all agree that government is not perfect, but we also have to keep in mind that the private sector is not perfect, either. This is about trade-offs and trying to find the right balance.

Two obvious things: private sector didn’t do a very good job of pricing the risk in the sub-prime market, and it also introduced a lot of products that are often praised as being predatory teaser rates, no income, no job, no asset loans, et cetera. It’s fun to beat up on the government, and there are lots of things to beat up on it for. As was noted earlier, I did work for the government, I certainly saw very clearly that there were serious limitations on what it could do, but I look forward to the conversation, so I’ll try and be brief here, and just point out that in some ways, I feel like I’m the outlier here.

It is true that I have a law degree, but I’ve never practiced or taught law, and I am an economist as well, but I think the role here I’m playing really is to talk about a progressive agenda here, so I find amusing, particularly here, that we don’t call ourselves liberals anymore, so we don’t have to worry about classical liberal—and what all that means, we just talk about ourselves as being progressive. So full disclosure here, I represent no one. Thank you, Larry, for setting that up.
So, I am on the Mortgage Finance Working Group that’s convened by the Center for American Progress, which is considered a progressive think tank. I’ve also done some work for the Bipartisan Policy Center. I’m not going to lay out exactly what I’ve been paid and whether I took the taxi or not, but thank you for setting that up. [Laughter] And particularly, I helped them think through ways to bring in more private credit risk, taking capital into the housing finance market.

I also authored a paper here with a professor at Wagner in 2010 called Improving U.S. Housing Finance through Reform of Fannie Mae and Freddie Mac: Assessing the Options, so you can find that on NYU Furman website if you’re interested. It is now a couple years old, but I think it covers many of the issues, if not all of them, quite well.

As I said, I’m not speaking for any of those groups, but I do intend to lay out a little bit of a different perspective than I think you’ve gotten from other people here. I’m also not going to discuss the lawsuit. I have found the rest of the day incredibly fascinating to listen to the legal discussions about bankruptcy and taking and all of that, but I do want to point out that the value of Fannie/Freddie is completely dependent on it having the ability to offer a government guarantee on the MBS. I just think that’s a fundamental thing to keep in mind when we talk about valuation, et cetera, here.

So much of what we’ve heard makes a lot of sense. I think generally, the consensus is for better regulations for safety and soundness for borrowers, lenders, and investors. We didn’t get too much into QM and QRM, qualified mortgages, but as a question, is that enough here? And QRM does not really have a loan to value. And that has been explicitly taken out, although it’s left in as an option. We all are for minimizing systemic risk. We want to make sure that, if possible, to eliminate not just the bust but the boom here, so I think all of us would agree, there is perhaps a role there for government.

Everybody agrees to phase out Fannie and Freddie. It is a flawed model, with the implicit guarantee of their debt, and their ability to build a portfolio that could allow them to increase their profits year over year by having access to very low borrowing costs, and I think we all agree that we should be protecting taxpayers. Interestingly enough, taxpayers are now
nearly paid back, and are making money hand over foot here, for reasons I will talk about in a second.

Another thing to remember is that Fannie and Freddie do both single family and multi-family. Sometimes, we just seem to be talking about home ownership. I think the issue here is about the housing sector, and whether it should get some sort of preference. I don’t hold the view that Fannie and Freddie provided a subsidy, but some people interpreted the guarantee, meaning they can get a lower borrowing rate, and that somehow is a subsidy. We’re into economics, so it’s about jargon there as far as I’m concerned.

Do you believe that housing, stability of housing, and home ownership have externalities towards the American dream, specifically? If you don’t believe any of that, we shouldn’t be sitting here, so I think I would certainly think that housing is pretty fundamental to our economy, maybe even fundamental to our democracy, and we should pay attention to what we can do to try and make it help to strengthen our country.

Another point I want to make here is that a large secondary market is critical to fund our existing and future mortgages. Anybody can talk about why don’t we just get rid of Fannie and Freddie, and if the secondary market isn’t there, oh well. Let’s face it, it’s $12 trillion in the single-family and multi-family mortgage market. The banks hold maybe a third of their portfolios in mortgages. They shouldn’t hold any more, probably; they should diversify their risk. They also have short duration. They view their funding of deposits as being short-term, and so they don’t like to make long-term lending. So you get rid of the secondary market. Where is the money going to come from, right, and if you don’t have it, what’s going to happen on housing prices, what’s going to happen to land prices? Maybe that’s a risk worth taking, but I think we really need to understand here, but if the level of mortgages available in this country falls substantially, it will have major implications for housing prices, and not just home ownership, but for land prices as well. Maybe we should start with a clean slate, but we don’t have one. We have a $12 trillion mortgage market out there now.

I spoke this morning, so I won’t spend any time on this: the Affordable Housing goals and CRA did not cause this cri-
I’m happy to go over the facts as analyzed by many different economists here. I know Peter Wallison has a different point of view, although he has written about it in a number of places here. The one thing I would just point out here is that there seems to be the assumption, first of all, that through Fannie and Freddie, it was poor people who did this thing, and that’s just not true. It was the Alt A that was the main problem here. There is no bright line for loan to value.

It is true that if all you care about is the safety of the capital markets, then you would like lots of equity there, so that makes sense. But a lot of very low down payment loans perform very well, and bad loans perform very badly. Pick a pay, underwriting to the teaser rate, so people couldn’t afford it once the rates went up, as they said, no income, no job, no asset loans, also remarkable to have. So, people point to the jumbo market and say, well, that’s proof that this won’t be a big increase in the cost if we go totally to the private market.

First of all, securitization of the jumbo market barely exists now, and it’s not clear how quickly it can be rebuilt, although I think it’s really important to do that. I’ll talk about that in a minute, but JUMBO is not comparable. The jumbo securitizations have 60% loan to value. They have FICO JUMBO near 800, 780, 790. It’s a completely different business, and so talking about comparing jumbo to the vast bulk of the market just doesn’t make any sense. We live in New York, and have some high cost housing here, but JUMBO, above 625, which it is now, or above 417, which is what it was, is a tiny tale of the housing market, just a little, small part of the distribution. So it’s just silly to talk about that being proof of anything.

On the other hand, I’d love to get beyond ideology. Let’s go out and test what happens as we try and bring back the JUMBO market. So let’s go out, let’s crowd in the private market above 417,000, and just increase the G-Fee until the private market comes in, that way we’re opening up the whole private market at once. We’re not doing it in little tiny stages, and then we can complain that the private market isn’t doing anything. Let’s give them a shot, right?

And then let’s look at what the cost of mortgages are. Let’s look at the kind of products that are offered, and jumbo markets tend to be shorter duration mortgages, and adjusta-
ble. If it works, that’s fine, but we’re not going to go jump off a cliff right now and just get rid of Fannie and Freddie and this part of the market, and somehow pray that the secondary market is going to fill in there quickly enough. But there is a sensible way to do that. Probably politically, that will never happen, but we’re here talking, so we can always do that.

A last piece of the framework here is that a high percentage of home owners and renters are overburdened. They pay more than 50%, or might pay more than 30%, or many more than 50% of their income for housing. Should we care? I leave you with that question.

So, the basic outline of our proposal on the progressive side—and this is something put out by the Mortgage Finance Working Group that was convened by the Center for American Progress, and the Housing Policy Council of the Financial Roundtable and many others, and the Bipartisan Policy Center, the Corker-Warner Bill—is that we’re going to keep FHA. I think there’s a lot of disagreement about what FHA should look like, but we’ll keep FHA where the government has 100% of the risk, taxpayers have 100 percent of the risk, we’ll keep that part, and we’re going to provide a guarantee on MBS, backed by loans that meet standards of safety and soundness. This would be the new confirming market, would look a lot like what we have now, will be safe and sound for borrowers, investors, lenders, and taxpayers. And I should mention here that FHA accounted for over half of the home mortgage loans that were home purchased loans at the peak of the crisis here, FHA and V, A, FHA insurance accounts for almost half of first-time home buyers in 2011, and over half of all homes purchased by minorities, so the government role here has been very, very significant, and obviously, what it has done is important to preserve here.

The basic perspective here is, home ownership and housing finance, and the housing finance system play a unique role in ensuring strong families, neighborhoods, boosting the overall economy, so here are the ten essential goals, and I will not spend any time going into them, but this is worth having the conversation.

The first and foremost principle from our point of view is that a new housing finance system must place the nation’s housing needs at the center of the system, both home owner-
ship and rental, and that is in contrast to most proposals, which place the capital markets at the center. This doesn’t mean the capital markets aren’t important, but it just isn’t everything. The system should enable a deep liquid market that will track capital and keep credit affordable through providing a government guarantee, preserving the TBA and the long-term fixed rate mortgage. I assume you all know what the TBA market is, but that’s to be announced. This is a highly liquid market. It is made liquid by the government guarantee. It allows rate investors who are willing to buy longer-term fixed rate mortgages to do so.

The system should protect taxpayers—incredibly important here. We don’t want to have to bail out the private sector or everybody, and so higher capital requirements all make sense. The government should charge for its lost reserve, and should charge a premium. The system now was complicit, and we still had to bail them out; and I’ll tell you, there’s a lot of conversation here that governments shouldn’t bail out entities. Well, badly run entities shouldn’t be bailed out, but when the whole system fails, trust me, the government is going to come in. So systemic risk is a very different thing than people often think about individual failure, institutional failure.

Mortgages should be available through all economic and business cycles. We saw the private capital totally withdraw from the mortgage market. If it weren’t for FHA, we wouldn’t have had a mortgage market, and housing prices would have collapsed even further. The system should ensure that all creditworthy borrowers have access to the mainstream housing finance system, regardless of demographic characteristics, geographic location, or housing type. That’s one reason Fannie and Freddie were set up. We didn’t have a national mortgage system back then, and there were parts of the country that were very poorly served by lack of local financial institutions.

The system should include provisions for access to the mainstream housing finance system. Here, we’re talking about a proposal, it’s something called the Market Access Fund. The private sector should do what’s profitable for it, but there’s no reason the government can’t provide incentives for them to look for innovative ways to expand who can be served.

There needs to be a system to provide flat financing to preserve the existing privately owned affordable housing stock,
and support the construction preserve the existing privately owned affordable housing stock, and support the construction of new affordable units. This is all about rental housing; it's extremely important and we seem to have a relative shortage of it. The price of rental stock is going up, and it's important for us to help increase that supply.

The system should provide access to a level playing field for both large and small lenders. This is a whole other political issue here people are worried about, that only the large banks in this new system will be originating mortgages. We obviously don't want that to be the case. I do still have risk with J.P. Morgan Chase, but I still don't think they should be the only lender for home mortgages.

The system should also include strong regulatory tools, and as I said, it was pretty clear from everybody here, the regulatory system is extremely important here. We have to make sure it doesn't overlap. There are lots of problems here, but I think we'd all agree that we need to focus on making sure that the mortgage origination market is well regulated, and that there's a level playing field. We don't have what we had in the crisis of before, this race to the bottom led by non-regulated firms.

That's the basic outline of my perspective, and a perspective from a progressive point of view.

[Applause]

Professor Levine: Thank you. So I have a question for as many panelists as would like to answer it. I heard a bunch of really interesting suggestions from a technocratic policymaking point of view. If we got a group as smart as this together, I'm sure that we could make major improvements, even if we wouldn't get it perfect. But I note that it has been both explicitly and implicitly acknowledged that the American public has a taste for housing. It has been encouraged to have a taste for housing, and old habits die hard. It's risk-averse, which is why things like lockups and fixed-rate mortgages and so on are so politically salient. So, I look at the world, and I see red state elderly people demanding that the government keep its hands off their Medicare. I see unions that have been arguing for 75 years that we ought to have socialized medicine, wanting to be excluded from the system to the extent that it provides benefits less than the ones that they already have in their contracts.
Okay, I see red state farmers demand that the government protect them from price fluctuations. I haven’t even gotten to broad electoral issues, I haven’t even gotten to capture issues and organized interest issues. What of all this package is conceivably doable? All these things you’re suggesting, what’s doable?

**Professor White:** First of all, I think that—

**Dr. Calabria:** Well, we ought to have the Washington guy—we’re mere New York, 200 miles away from the beltway. That’s a Washington question.

**Dr. Calabria:** Obviously, I work at the Cato Institute, we don’t think about what’s doable, we think about what’s right, but that’s—

**Professor White:** Oh, alright, there goes that suggestion.

**Dr. Calabria:** That caveat—exactly.

**Professor Levine:** [Crosstalk] The real question is, if you’re going to try to do policy, it would be interesting to know what kinds of policies you imagine we could do.

**Dr. Calabria:** So, I expect higher capital standards, for one, are doable, although certainly, you could never get them high enough so that in my opinion, we still wouldn’t be massively leveraged. We would be less massively leveraged, so that’s certainly one part. It’s disappointing that at one point, it certainly seemed as though that we might have down payments as a part of the mix was doable, but now that’s sort of completely off the table. Having this on budget is probably doable, although I’m not—I’m far less convinced that that actually delivers a better system or not, but it’s worth keeping in mind that all government insurance programs are cash flow. We take the money in, we spend it, so there’s no lockbox anywhere, and there won’t be a lockbox Corker-Warner, there won’t be a lockbox for any of these processes, so to me—

**Dr. Willis:** You don’t consider FDIC—

**Dr. Calabria:** Okay, FDIC takes deposit insurance. They put it in treasuries. It gets spent, so again, it has got pieces of paper that are promises, there aren’t physical, real assets. Their claims don’t have real assets behind them, except to the extent the government has a claim on all of us.

**Dr. Willis:** They do not hold gold.

**Dr. Calabria:** They don’t hold anything other than the promise of [crosstalk] to take my resources away from me, but
again, that’s a whole other conversation. The point is, they’re all cash flow, so having it on budget in that way does not give me a whole lot of comfort. I was the lucky guy on the Banking Committee. They gave me flood insurance, FHA, and at Fannie and Freddie, I’m also absolutely convinced, having worked in a number of programs, that we’re going to go bankrupt. So it’s nice to know that since I’ve taken myself out of the equation, they’re still going bankrupt, so I’m certain it wasn’t me, but that said, it’s not clear to me that any major positive improvement is possible, to echo what you’re saying. If I was a betting man, I would bet that in ten years, Fannie and Freddie will still be around.

**Professor Levine:** Larry, you had a great list. I’m not being facetious. What on that list could be done, and if this list can’t be done, do you have any second best items that could be done?

**Professor White:** Oh, man.

**Professor Levine:** Let’s get rid of the mortgage interest deduction first, right?

**Professor White:** Yeah, right. Look, speaking truth to power is what an academic is supposed to be able to do, and the feasibility, gee, I’m the wrong guy here. However, there’s one thing, one thing—we’ve been talking context all day, and I realize that there’s one piece of context important to remember. We went through a housing boom. For reasons I don’t fully understand, because that’s not what we teach at the Stern School, the participants in the housing market came to believe housing prices will only go up. Why, I don’t know, but remember, there are some important implications from that.

First, if housing prices will always go up, then mortgages will never be a problem, because even if the borrower is hit by a truck, loses his or her job, he or she can always sell the house at a profit, because housing prices are always going to go up. So he or she can pay off the mortgage that way, and if mortgages are never going to be a problem, then mortgage securities will never be a problem. But also, anybody in this system is no longer going to worry about down payments, is no longer going to worry about credit history, is no longer worried about income and jobs, because housing prices will always go up. So remember, this is the mindset.
I don’t understand it, but that’s what everybody in the system was believing. Yes, there was moral hazard on top of that, but why did those bad loans get made? Well, because everybody believed housing prices were going to go up, and so you don’t believe that’s a bad loan.

Professor Reiss: I would just be the Polyanna for the Panel, and I think that technocrats have actually been making some progress. I just think that the fact that the Obama Administration had its three options, including privatization in its white paper in 2011, was a dramatic public shift. I think the Treasury, under Democratic and Republican administrations, has been critical of Fannie and Freddie, and we’ve seen, a major shift, even in the public, on whether Fannie and Freddie are angels from above, saving us, or big problems. So what I would hope is that if the public discourse changes and says, we don’t want to have a hybrid model like Fannie and Freddie, we don’t want to have privatization of profit and structuralization of loss. If we just achieve that, I’d be really happy.

If we just said, we wanted private capital to take a first loss position of some small percent, I would be happy with that, and I think the public conversation is changing, at least for some of these big issues, and we’ll have a new system, and we’ll have new crises for that system, but I think a rejection of the hybrid model is a very realistic, good first step, although Mark is now making me feel very depressed about that, too.

Professor Levine: You had this long list.

Dr. Willis: Well, I think reform is going to happen, and I think Corker-Warner is the beginning of a discussion here. We’re going to end up with a federal guarantee, and it’s going to be paid for in some way. On the Federal Credit Reform Act are budget rules, so there will be no budget implications of it. I don’t really see a problem. I mean, there is this ideological fight here about government being involved, but in terms of it being possible—and I’ll just mention, Britain got rid of the mortgage interest deduction. They did it over 20 years. It’s possible to do.

Seeing a reduction of it, stepping it down, I think is definitely possible, maybe down to 500,000, or more than that—?

Audience Member: It’s down from a million.

Dr. Willis: It’s a million, that’s right, right. FHA – there are a lot of things going on there to fix it, right? I see lots of
pieces here that have gotten better, and my colleague, same name, Mark, said that he thought Fannie and Freddie wouldn’t have made it even without the Alt A problem. It was a close call. The two-and-a-half percent was almost enough capital if they hadn’t done stupid loans, so—

DR. CALABRIA: If I could make two quick points, which is, as somebody who was working on GSE reform a decade ago, the political equilibrium has shifted. It’s not 100% clear to me what that means, I’m not sure that I thought I would ever live to see a Democratic president say on national television that Fannie and Freddie should be privatized, so that, to me, is a fairly big change. I will say that one of my concerns is, and this is quite honestly—it’s not an ideological argument against government—my concern is that we might start out with something today, and a post-crisis environment, when we’re like, oh, yeah, that was all kind of reckless and silly. Is that politically durable during the next bubble?

For instance, 90% of the loans under FHA today—and I appreciate FHA was made decades ago—but 90% of FHA loans today would not have been eligible when FHA was created.

PROFESSOR LEVINE: Just to reinforce that, look at the 1986 Tax Reform Act, how that comes out.

DR. WILLIS: Eighty years, they haven’t called on the federal government—the FHA has been making these loans for 80 years, maybe not all of them the kinds you’re talking about from the beginning, but certainly, in recent history, and then doing fine, and then everybody who predicts somehow, it’s going to be a disaster, you’ve got to remember that everybody said Fannie and Freddie, they’ve drawn 180 billion, next year it will be 200, right? The pig has moved through the python, FHA has greatly tightened its underwriting, it has greatly increased its G-fee, here—

DR. CALABRIA: Again, I guess I would say, I’m fairly certain I will see another boom and bust in the housing market in my lifetime, and so my concern is not—

DR. WILLIS: So how can we avoid it?

DR. CALABRIA: I haven’t heard a proposal to get rid of it.

DR. WILLIS: Privatizing kind of ensures, to me, that you have a boom and bust. [Crosstalk]
PROFESSOR LEVINE: Have I been provocative enough? Yes, Larry—

PROFESSOR WHITE: Okay, but look, the size of the collapse of the housing market is comparable to the collapse of the tech boom. It’s a $7 trillion loss of housing value, $7 trillion loss in the tech boom between end of year 1999 and end of year 2002, three years. Those are all Federal Reserve flow of funds data. We had a recession, following the collapse of the tech boom. We didn’t like it, nobody likes to lose $7 trillion. We moved on. We had a $7 trillion loss in the housing market, maybe a trillion and a half—that’s Mark Zandy’s estimate—slopes over in the financial sector, and we go through the great recession, and a near-meltdown of the financial sector. We may well go through another housing boom, but it’s terrifically important to make sure that large, systemic financial institutions and anybody else who could create runs and other corrosive outcomes are well enough capitalized so that we don’t see a meltdown, we have a mild recession, we don’t go through another great cycle.

DR. WILLIS: Let me just add to that, if we bring in private capital ahead of the government guarantee, then we are spreading the risk of the mortgage business outside of the home, housing finance industry, just is—underlines, double underlines your point here.

PROFESSOR WHITE: Okay.

DR. CALABRIA: And so to clarify something that Larry said, to me, the primary difference between the dotcom bust and the housing bust is, the dotcom bust was an equity-driven bust, and so part of what I would have gotten to with a little bit more time in my comments is, I think part of the conversation on both the financial institution level and the household level is more equity. I believe people still aspire to be homeowners. I do not believe people aspire to be drowning in debt. and so I think going back, and again, the hard part here, and here’s where I will be very honest where I differ, and maybe I’ll pick on Mark a little bit, but sort of—

PROFESSOR WHITE: That’s what I’m here for.

DR. CALABRIA: What’s so progressive about housing prices out of the reach of normal families? I think a fundamental goal of policy should be—you look at some place like San Francisco, median house price, eight times median income.
Incomes are not going to grow 800% in San Francisco. Our objectives should be, in markets like San Francisco, New York—and I know a lot of people here probably own property in New York, our objective should be for prices to fall, because housing is a basic necessity of life, and when it becomes more expensive, that’s a bad thing, not a good thing. It is this confusion in my mind between having something be an investment and consumption. Housing is consumption.

Professor White: I think I agree with everything you said.

Professor Reiss: I don’t agree with that.

Dr. Calabria: Where’s your house?

Professor Reiss: In Brooklyn.

Dr. Calabria: Brooklyn!

Professor Reiss: But I can’t believe that you’re saying that. You’re saying that we should—so what are we saying, that there’s a distortion in the housing market in New York, or just that there’s high demand for housing?

Dr. Calabria: Here’s what I’m saying, is that in most markets in this country, supply—I mean, even—

Dr. Willis: It’s not the lumber [crosstalk].

Dr. Calabria: Supply is relatively inelastic; it’s vertical. These subsidies are demand subsidies. We know from Econ 101, you have a vertical supply curve, you shift out the demand curve, you don’t get extra supply, you get demand, but you get extra price increases; and so even at the height of the bubble, 2006, we were building 2 million units. That sounds a lot, but keep in mind, the housing stock itself was about 120 million units, so even over the course of the bubble—and I think it’s also, we’re saying, this is—I’ll pick on Mark, the puzzle a little bit, which is, it’s not Texas that got us in this mess.

Dr. Willis: No, Dallas.

Dr. Calabria: It’s California.

Dr. Willis: There’s a lot of local regulations.

Dr. Calabria: So the supply constraints are a big deal.

Professor Levine: Okay, let’s give the audience a shot. Go ahead. Please identify yourself.

Ms. Helene Jnane: Yes, good afternoon, thank you, yes. My question is—

Professor Levine: Please identify yourself.
MS. JNANE: Oh, my name is Helene Jnane.

PROFESSOR LEVINE: Mm-hmm, and who are you affiliated with, if anyone?

MS. JNANE: Not affiliated with anyone, myself.

PROFESSOR LEVINE: Okay, all right, that’s allowed.

MS. JNANE: Actually, I am a candidate for City Council.

PROFESSOR LEVINE: All right.

MS. JNANE: Yeah, here in New York. My question is pretty fundamental, and basically, to Professor Reiss, maybe to the whole panel, but it goes to one of the three principles that you mentioned, that you said is fundamental to our discussion, and I think that it is, because it’s a question for me: not whether or not something is doable, or whether or not the government is a perfect or imperfect actor in the market, but whether or not the government has the authority, under the rule of law, to do the things it does, and to involve itself in the market.

You said that no one here would disagree with any of your principles. I actually disagree that there is a human right to housing, and I think that for me, again, I don’t find that right in natural law, I don’t find it to the U.S. Constitution. For me, a right would be like a right to life. It doesn’t require me to force anyone else to do anything, it just—that right is to be respected, people leave me alone, and obviously, I have a concomitant right to self-defense. We have delegated that right, or that authority, excuse me, to protect life, to the government, whereas a right to housing, would require the government, say, to use force to require people, or for me to use force to require people to respect that right. So I guess my question is, to Mr. Reiss, where do you find authority for that human right to housing?

PROFESSOR REISS: I think I may have misspoken. When I was talking about these ethics, I wasn’t saying that we all agree with all of these ethics, but that this is part of the discourse, so I do not agree, although there are places in the law, in the 1948 Housing Act, there is some language to the effect of affordable and decent housing for all, and in the New York State Constitution, isn’t there supposedly—

MS. JNANE: There is, but it’s not a must, it’s a may.

PROFESSOR REISS: Yes, but I think I must have misspoken if I had said that this is a right, but I’m saying that this is a way
that we talk about housing that is throughout our discourse about housing, and it should be acknowledged, and that it drives how many people think about housing.

PROFESSOR LEVINE: Richard?

PROFESSOR EPSTEIN: Yes, I have an observation and some questions. First of all, I think on the durability point, what was said by Michael is, in fact, accurate. The 1986 Act was just the prelude for another set of special interest deals, because there was no constitutional glue that held this thing together, and on that issue, that’s one of the reasons I’ve always liked flat taxes, is they’re less subject to political manipulation, and in the end, I think the distributional effects that you hope to get from progressivity and so forth are a snare and a delusion, because they then encounter a whole variety of special favors that go to the people with the special brackets, so the political equilibrium is always destructive.

But the point I think that’s relevant here goes to what Mark Calabria said, which is that high prices are not a social end. Home ownership is not a social end. The social end is essentially to try to have the intersection of supply and demand so that prices reflect opportunity cost.

You take a place like New York City, if you are trying to work a system of financial reforms without using a system of land use reform, you will never get the price levels down to sensible elements, you’ll never do it so long as you keep a stabilization program in place with a dual effect.

My daughter is a developer. I’ve watched this thing from up close, and it’s amazing. You cannot put up a major development in this city unless you go through three to four years of preliminary negotiation, and then you are subject to affordable housing constraints, to access constraints, to aesthetic constraints, you’ve got to make deals with the subways and everybody else, and what has happened is, the size of constraints is such that you tend to kill off 90% of the deals that otherwise take place, and the affordable housing units, in effect, they are subsidized, but it creates all sorts of distortions everywhere else, and that I think what you need, and I’m wondering whether the panel would agree with this, is if you could remove the constraints on the supply side, then it seems to me that the prices would go down in a rational kind of fashion by taking the cost out, and if you take the constraints out on the
supply side, you’re going to get rid of the need for the subsi-
dies on the other side.

What we do now is, we have two things that for individu-
als, cancel each other, but both of them accumulate to social
losses. So as Michael Levine wants to know what I think we
ought to do, I think we ought to think more of deregulation
on those markets. I don’t know whether it’s feasible, but I
would hope that to some extent, it now becomes so, because of
the two-tier system, which has developed in places like New
York, as a function of this regulation, is in fact something that
good populists like myself can treat as an appropriate target of
attack. You notice I called myself a populist. That’s just for rhe-
torical—

DR. WILLIS: Are you running for City Council?

PROFESSOR EPSTEIN: Yeah, I’m going to run, too, in Chi-
cago.

PROFESSOR LEVINE: Did you want to say something?

AUDIENCE MEMBER: So I wanted to just go back to some-
thing Mark said about whether or not government played a
role—this Mark. So I will admit, my prior was the Wallison
view, that government activity was a huge cause here, because
we didn’t see collapses or the kind of bubbles in other securi-
tization markets where the government wasn’t active, or credit
cards and factoring and all sorts of other areas where there was
securitized activity, but let me ask a specific question, just to
give you an anecdote and see if you react to this.

So, my friend is a mortgage broker. He is very active in a
large American city, pushing subprime loans for a major
American bank in the run-up to the crisis, and I asked him,
and he doesn’t really have an ideological dog in this fight, and
I said to him, would you guys have done what you did, but for
the government’s actions? And he said, look, we’re always out
there trying to push stuff on people, good or bad, to use your
terms—but he said, but we are cautious, because the govern-
ment is always looking over our shoulder and could come
don on us, and they’re encouraging this in various ways. He
said, once they turned on the this is okay, that these kinds of
loans, we will buy them, that just gave us the green light to go
full force, and if we weren’t playing with them and writing
these loans that they were buying, we were at a huge funding
disadvantage vis-à-vis our competitors. So if they’re giving a re-
ally good deal for particular types of loans, they would say, oh, we want—we’re only going to give you 20%—they would be completely out of business.

So once the government gave this kind of—I was a geology major, so water going down the path of least resistance, all the water just deluged down that, and of course, we got froth in it, so I just want to—is that totally wrong, or . . .

Dr. Willis: So, there are two parts. The first part is, commercial real estate looked the same as the home finance thing, and it collapsed also, and I don’t think anybody is arguing government had an influence there, so we were in a bubble. Why the bubble started, there are lots of legal terms, dirty hands here, I’m not—but to argue that, specifically, in this part of the market, you need some sort of theory, like you just expressed there, I don’t know what it means that the government was willing to buy these. So are we talking about Fannie and Freddie were willing to buy them? They didn’t buy these worse things, and they lost market share.

What they did, like any good capitalist, when they lost market share, they started competing, and we had this race to the bottom. They did not start that syndrome here, and we can look at history, and most of the Alt A stuff, for example, that they did, was to middle class people, it wasn’t low and moderate income. I ran community development for J.P. Morgan Chase for many years. We did not do bad loans. We had regulators. I think the regulators, in the end, didn’t do what they were supposed to, and we can talk about Greenspan, we can talk about the predatory lending, and the issue of regs in 2008. If they had issued those earlier—I’m not saying we wouldn’t have had a bust, it just would have looked different—but the loans that were done under CRA, you can get some quotes from somebody that some small banker who did something outrageous and thought it was justified, but it didn’t happen in the large institutions.

Professor Levine: The other Mark?

Dr. Calabria: First, I’ll start with where I agree with Mark, which is, if you do track commercial, office, retail apartment prices, same boom and bust.

Where I depart from Mark is, it’s not federal government, it’s local governments, and land use controls, too, as Richard mentioned, so it’s very difficult to build new apartment build-
ings in San Francisco, too. So to me, the supply constraints across property had that bubble. Where I will depart is, I do think that despite the fact that we had bubbles, and of course I think monetary policy played a very big role in that, in my opinion, which is again, government. But that said, I do think housing is slightly different in that—and I’ll set aside the 500-plus small little banks that failed because of commercial development loans and such, but you didn’t see in a very big way, the losses in the commercial property market transfer to the taxpayer in the same way, and so I’ll push back on at least one thing that Mark said, which is, you often hear this, that Fannie and Freddie have lost market share.

That ignores the part that Fannie and Freddie were buying 40% of the subprime private label securities, and if you add that to their market share as an investor, then their market share is still a majority of the market, so to me, they were the—and if you look at, the subprime market doubled when Fannie and Freddie doubled their purchase of private label securities. You can say they bought the AAA pieces, that’s fine, they were the driver in that market—

DR. WILLIS: You missed my confession this morning. I did say that they may have accelerated, but they didn’t hold the B pieces. Somebody else took the real risk.

DR. CALABRIA: Sure.

DR. WILLIS: David is trying to get in.

PROFESSOR REISS: So, this is just to respond to Richard’s comment about the supply constraints. I don’t know if the supply constraints caused the bubble, because the supply constraints pre-dated the bubble, but I do think it’s a really important issue. Edward Glaeser at Harvard and Gyourko at Penn have written about this, Richard has just referenced it, but I don’t think it has really been absorbed by a broader group of people: the notion that if you have supply constraints from local land use regulations passed by local governments, that no matter—all the money that goes in through financing or through increased demand because New York is really popular, is just going to drive up the cost of housing. It’s going to benefit the current owner, and it will not increase the supply of housing. And that’s key to a lot of issues, at least on the coasts, and worth reemphasizing.
Dr. Willis: It’s not Fannie and Freddie but I agree with that.

Professor Levine: Last question.

Mr. McCullough: I’ll say something on behalf of Fannie and Freddie, so we’ve been knocking them all day long. In one respect, anyway, they’re works of genius compared to the old S&L industry, which—whose problem was that it borrowed short and lent long back in the 50s and 60s and 70s, and then when rates went up, they went belly up in the 80s, so the Fannie and Freddie model is, they either pulled it on portfolio, but finance long-term mortgages with long-term bonds, I mean, houses should be financed with long-term debt. Maybe not 30, but at least 20 years, but then that should be funded with comparable average maturity debt that protects them against interest rate rises. There is the prepayment options, remember, people like to have a prepayment option, unless you put points on, or you’re going to have to charge for that with a higher coupon, but the investors should get that higher coupon.

Professor Levine: Don’t run for office on it.

Mr. McCullough: In order to—pardon?

Professor Levine: Don’t run for office on that platform.

Professor White: Right. Dwight Jaffe says it’s 50 basis points to not be charging for a prepayment.

Mr. McCullough: Yeah, well, they offer you a menu, here’s how many points you can get, here’s your coupon, and people—there is the opposite risk, though, which Bob Van Order pointed out to me, that given the prepayment option, then the bonds should be similarly callable, with a similar penalty. Apparently, back in 2004, The Wall Street Journal accused Fannie of cutting corners on that, and trying to borrow cheap non-callable money to finance callable bonds, and then they get the opposite risk—there’s no reason they can’t just hedge that by putting the same call provision and paying the same premium to the investors. I agree greatly with Larry that the mortgage interest deduction has been a big distortion here. I’d find home ownership to be someone who owns more than 50% equity in their house, so what’s this has been encouraging is home debtorship, not home ownership, encouraging people to stay in debts and make financial investments instead of paying off their house and then making financial investments, so
we’d have to phase that out over five or ten years to avoid the shock.

We phased out credit card interest back in ‘79 or so, I’m old enough to remember, we used to be able to deduct credit card interest, and we phased that out over five years to reduce the shock. This is bigger, so maybe ten years. It should be accompanied with a revenue-neutral across-the-board cut in income tax rates, so it’s not just a big tax increase. I’d rather see smaller taxes and smaller government, but somebody should tie it into the tax cut. This would make the whole financial sector smaller. It’ll still find ways to get into trouble, but when it does get into trouble, if it’s only half as big, it will only have half as big a problem, so I think that would be stabilizing all around to do that.

Professor Levine: I don’t hear a question mark on that, but what I’m going to do is ask you all to thank our panelists for an extremely lively discussion.

[Applause]

Professor Epstein: One of the rules of property law is that there are temporal as well as physical trespasses, and one of the reasons why, in this regime of weak property rights worldwide, I am especially happy to have organized this event, is that everybody expected the temporal limitations notwithstanding the fact that they had to leave some pearls of wisdom unsaid during the course of this particular discourse.

So I have another two minutes and 33 seconds in which to sum up the entire evening, and this is what I am going to say about this. What happens is, we start narrow and we go broad. We then constantly try to figure out how we can narrow ourselves again, only to broaden ourselves again, and I think that the following explanation explains why the system is so deadly, which is, to the extent that you have highly efficient private markets, in well-regulated circumstances they do an astonishingly good job; but to the extent that you have highly efficient private markets and highly dubious public policies, these new private markets tend to exploit the defects that are created inside the system at a level of rapidity which was unknown under some circumstance.

So, what it does tell you in effect is that getting the public side right is, in fact, going to be critical, and some years ago, I wrote a book called, Simple Rules for a Complex World, and what I
really meant by that, to some extent, is if you can get these guidelines that are relatively simple, you have a chance of keeping them relatively durable. If you tend to keep them relatively durable, what you tend to do is to reduce the risk from strategic behavior. And that what this suggests to me is that it’s not that distributions don’t care or matter, it’s that when you start having end states like home ownership as a good, you’re engaging, unconsciously, in an industrial kind of policy, and that what the government ought to do is to concentrate on the framework in which people make their decisions, rather than to make collective decisions for them.

I don’t expect everybody in this room agrees with me, but I think we all agree about the following thing, that the fact that people are still engaged in this debate, sitting more or less on the end of their seats, means that we can end covering ourselves with glory for having continued and contributed to civic discourse. So thank you all for coming.

[Applause]