

**Mortgage Bankers Association 94<sup>th</sup> Annual Convention and Expo  
Closing General Session  
October 17, 2007**

**Housing Finance and Market Liquidity**

by

**Allan I. Mendelowitz, Ph.D.  
Director, Federal Housing Finance Board**

All views expressed are the opinions of the speaker and do not represent the positions of the  
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## **Housing Finance and Market Liquidity**

### **Presentation Outline Prepared for the Mortgage Bankers Association 94<sup>th</sup> Annual Convention and Expo Closing General Session October 17, 2007**

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The most important lesson learned from the painful events of this past summer is that appropriate liquidity is the foundation of a healthy housing finance system. Excess liquidity both enables and covers up a multitude of sins. And, the absence of liquidity crushes all, without discriminating among those who are painfully affected. The amazing thing is that this is a lesson that has already been taught to market participants many times before. It almost takes on the dimensions of a biblical story: God gives the law and the land to the children of Israel; the Israelites have a pretty good time, but sin; God gets angry and punishes them. Then he relents, and the story starts all over again. Does it sound familiar?

In fact, it is because of the importance of liquidity that the Congress created government sponsored enterprises -- The Federal Home Loan Banks (FHLBanks), Fannie Mae and Freddie Mac -- to assure liquidity for mortgage finance. The legislative wording may be a little hard to follow, but the key aspect of their legislative charters comes down to assuring liquidity.

I want to take a few minutes to go over the history of mortgage finance of the past century, the role of GSEs in assuring appropriate liquidity, the causes of the current crisis, and some policy considerations for how we go forward.

#### **History of mortgage finance – the critical role of liquidity became apparent during the Great Depression and the Congress responded.**

- FHLBanks
  - In the Great Depression housing was devastated, with large numbers of families losing their homes because of an absence of liquidity for mortgage finance. Even credit worthy homeowners could not refinance their mortgages when the standard mortgage of the period – the five-year IO bullet – matured because of an absence of liquidity in the mortgage finance system.
  - Congress created the FHLBanks in 1932 to provide liquidity where needed to the primary suppliers of mortgage lending of the day – the savings institution, who were in our current lingo, portfolio lenders.

- This system of housing mortgage finance ensured good credit underwriting because the savings institutions held the mortgages they originated to maturity.
- The system did not, however, manage interest rate risk appropriately. The system worked reasonably well for half a century and then collapsed due to interest rate risk, dramatically rising interest rates (the Volcker monetarist experiment), and the rise of direct capital market intermediation drained deposits from savings institutions. When interest rate ceilings on deposits were lifted, the savings institutions found themselves laboring under high cost liabilities and low yielding assets.
- And, we all know what happened, the collapse of portfolio lenders due to interest rate risk.
- Rise of Fannie and Freddie – the solution to the interest rate risk problem through direct capital markets intermediation.
  - Over the past 25 years, great effort was devoted to learning how to manage interest rate risk.
  - While this was going on, the mortgage finance system still maintained high standards of credit underwriting. Because Fannie and Freddie held all of the credit risk of the mortgages they purchased, they became the “gate keepers” of credit quality for mortgages and mortgage backed securities.
  - Fannie and Freddie became large financial institutions and acquired substantial political power along the way. However, their growth and success attracted opposition:
    - i. private sector competitors,
    - ii. economists as “theologians,” and
    - iii. partisan political opposition.
  - The debate over the proper role of Freddie and Fannie focused on their benefits and costs as defined by their critics. And that definition is of the utmost importance, because if you have been around Washington for any length of time you know that the side that frames the questions put forward in any public policy debate is 90 percent of the way toward winning the debate.
    - i. the benefits of Freddie and Fannie were defined as how much they reduced the cost of prime conforming mortgages – about 25 basis points,
    - ii. the costs of Freddie and Fannie were defined as the contingent liability imposed on the public treasury – and most frightening of all, the dreaded specter of systemic risk,
    - iii. no one mentioned the role of the GSEs in assuring liquidity – their original *raison d’être*, and
    - iv. most of all, no one recognized that the private sector alternatives to the GSEs created significant systemic risks in credit markets.

- Fannie and Freddie remained politically and operationally unassailable until their accounting troubles surfaced in 2003, which made them vulnerable to new forms of restrictive regulation.
- Under regulatory pressure, Fannie and Freddie paid fines in the hundreds of millions of dollars, their portfolios were restricted, and their market share shrank. A substantial portion of their market share was lost to the private market and new institutional structures (*see Chart 1*).

### **Recent liquidity crisis**

- As mentioned earlier, excess liquidity hides a multitude of sins.
- The rise of the private market alternatives to the GSEs took place in a time of excess liquidity and the weaknesses of the new structure were not initially apparent.
  - Credit spreads compressed across the entire debt market – yields provided inadequate compensation for risk.
  - Market conditions encouraged a decline in credit underwriting standards (*see Chart 2*). This was a debt market wide phenomenon (private equity, LBOs, corporate “covenant light” loans).
  - Lower interest rates and public policy contributed to a housing bubble (*see Charts 3 and 4*). After a 50-year long period in which the real cost of housing (that is inflation adjusted) remained fairly constant, the real cost of housing went up more than 50 percent between 2000 and 2006.
- And as I said earlier, the absence of liquidity in the financial marketplace crushes all in its path – irrespective of how credit worthy or solvent you are – if you need borrowed funds.
- The crisis began in the mortgage markets because of rising delinquencies and defaults
  - Investors realized that they were holding risk that they did not realize they had and everyone headed for the exit doors.

### **What did we learn from this?**

The most valuable lessons we learned are:

- First, financial markets are not stable. How many crises do we need to experience to reach the conclusion that periodic crises will always be a feature of financial markets?
- Second, GSEs are critical to maintaining appropriate liquidity for housing finance.
  - FHLBanks funded over \$175 billion of additional loans to their members since the end of the second quarter – an increase in lending of 28 percent.
  - GSE MBS and debt was the only functioning part of the secondary market for mortgage finance.
- Third, Washington needs to take a time-out and rethink the current effort to alter the regulation of the GSEs. A better understanding of both financial market defects and the

important role of GSEs as providers of appropriate liquidity is needed to inform any legislative effort.

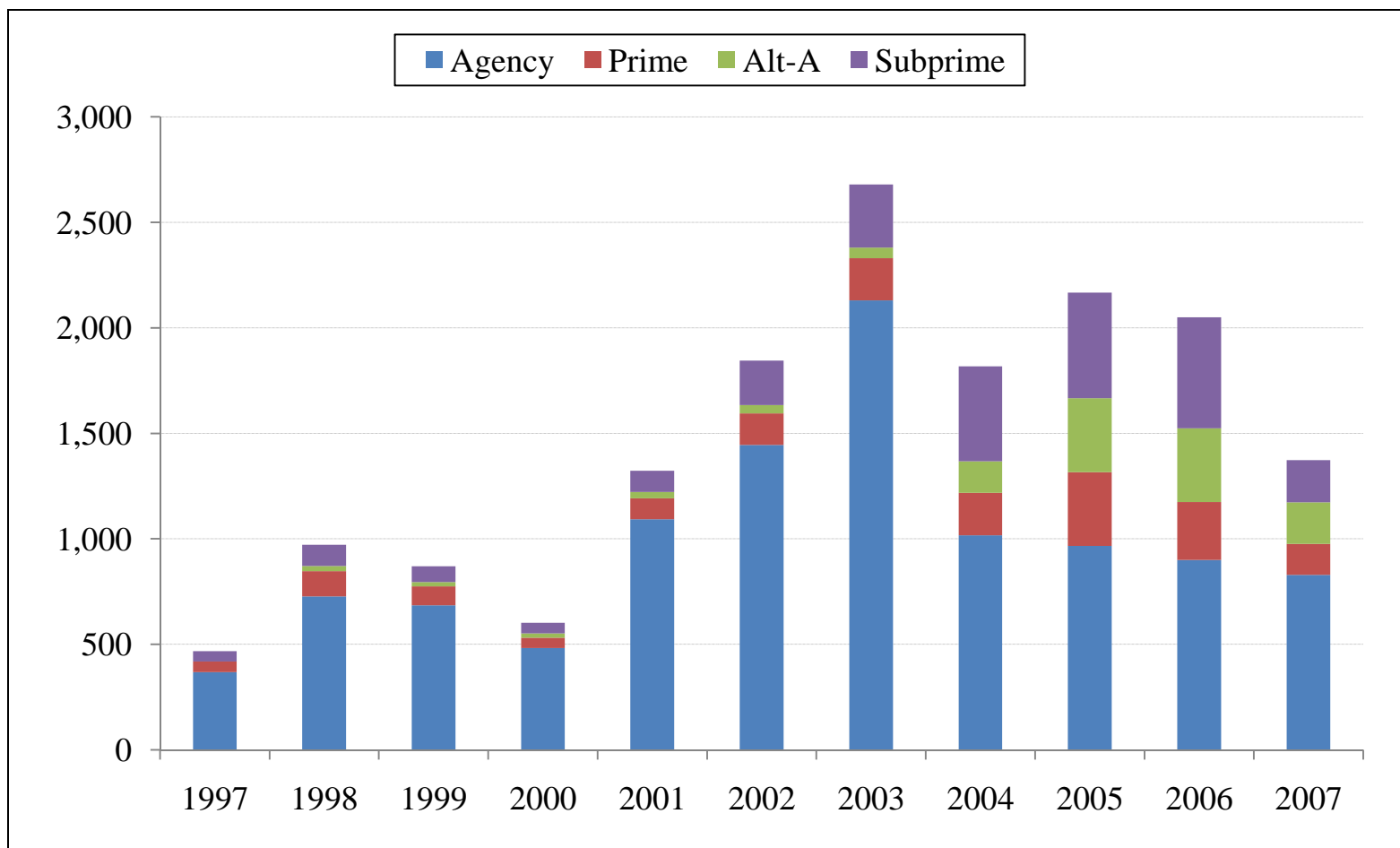
- Finally, while there have been claims that the GSEs create systemic risk, prior to this summer, few if any critics took note that the private sector alternative to Fannie and Freddie appears to present even greater systemic risk. While GSE systemic risk remains an untested hypothesis, we do know the systemic risk of the private sector alternative has been high and very costly as evidenced by the ongoing credit market crisis.

**Going forward – it will not be a good time for the housing and mortgage industries**

- The importance of GSEs and portfolio lenders – going forward will continue to grow relative to the last five years.
- The impact of housing problems on the economy will play out as a slow motion train wreck over the next eighteen to 24 months (*see Charts 5 and 6*). A substantial decline in home prices is all but inevitable over the next two years in many, if not most local markets.
- I fear that the current housing sector difficulties will more likely than not push the economy into a recession.

## Chart 1

### RMBS Issuance Volume (\$Billion)



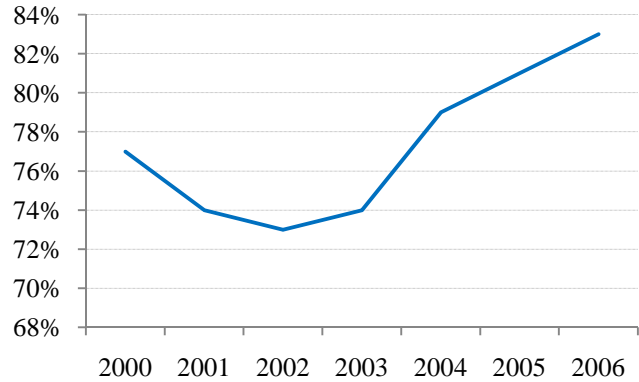
Note: 2007 figures annualized year-to-date through August

Sources: FNMA, FHLMC, GNMA, Fitch Ratings

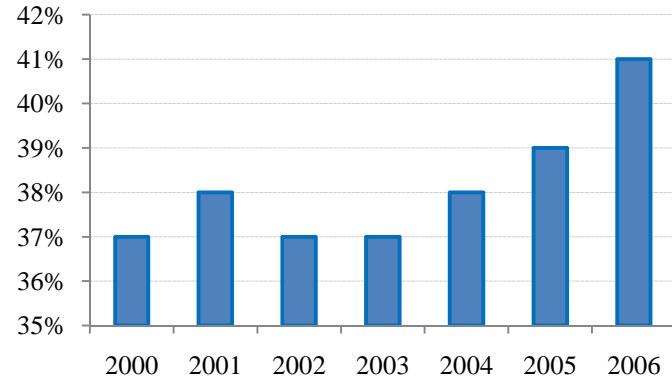
## Chart 2

### Evidence of Relaxed Credit Standards

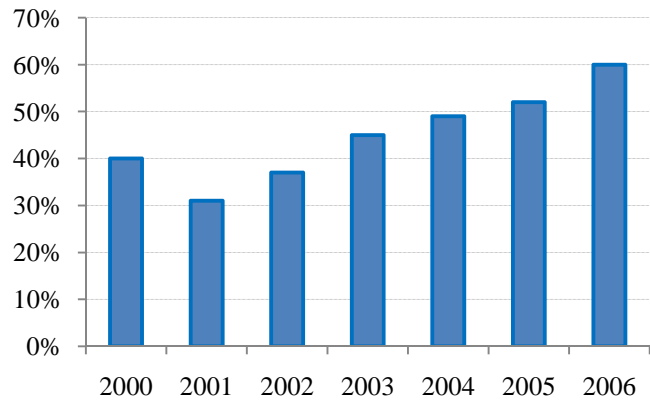
**First Lien LTV for New Borrowers**



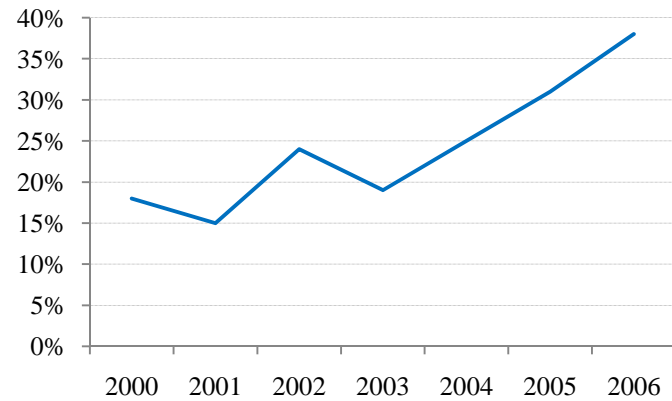
**Debt-to-Income From New Borrowers**



**% of Borrowers Using "Stated Income"**



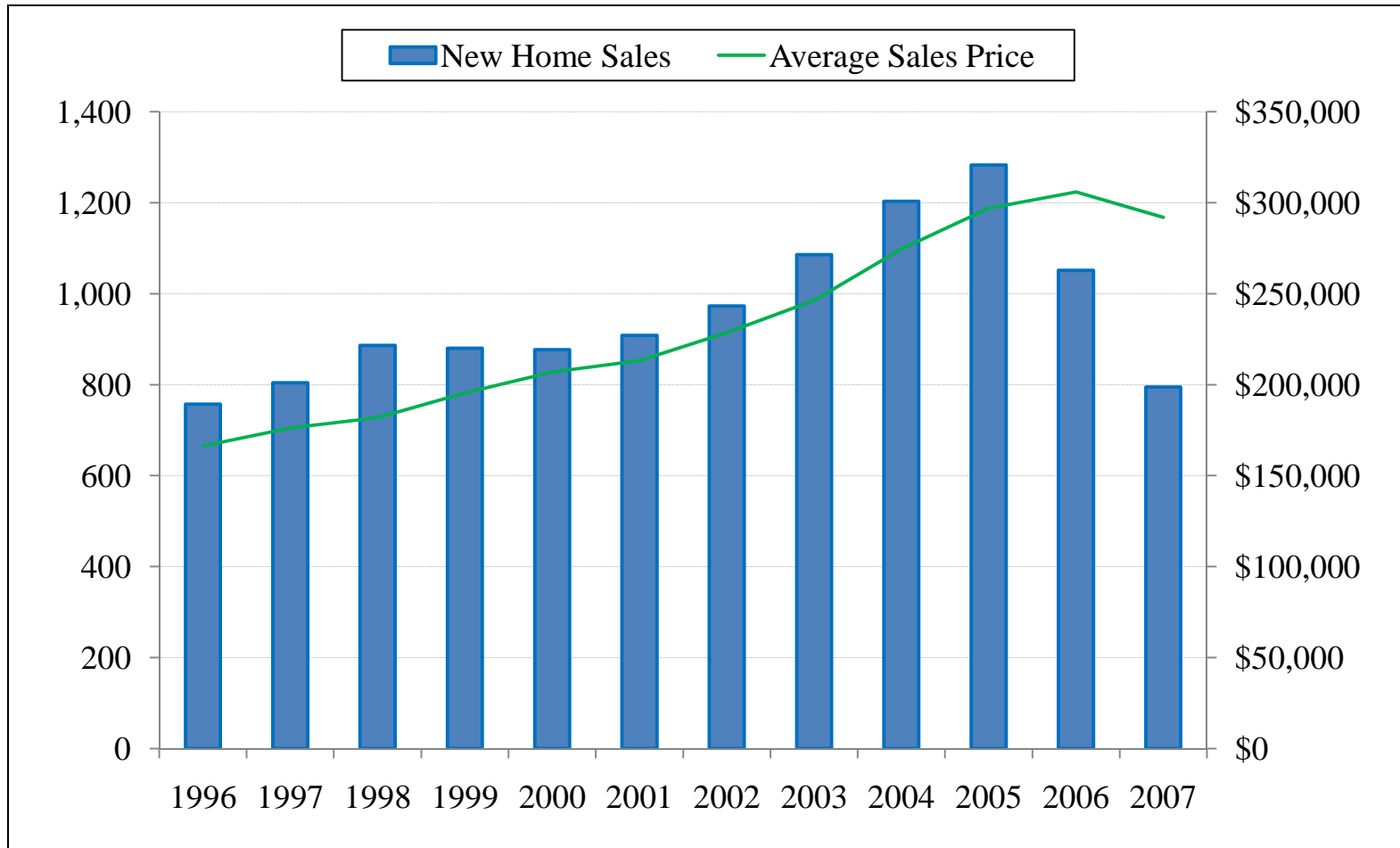
**% of New Borrowers with a "Piggyback" 2<sup>nd</sup> Lien**



Source: Fitch Ratings

### **Chart 3**

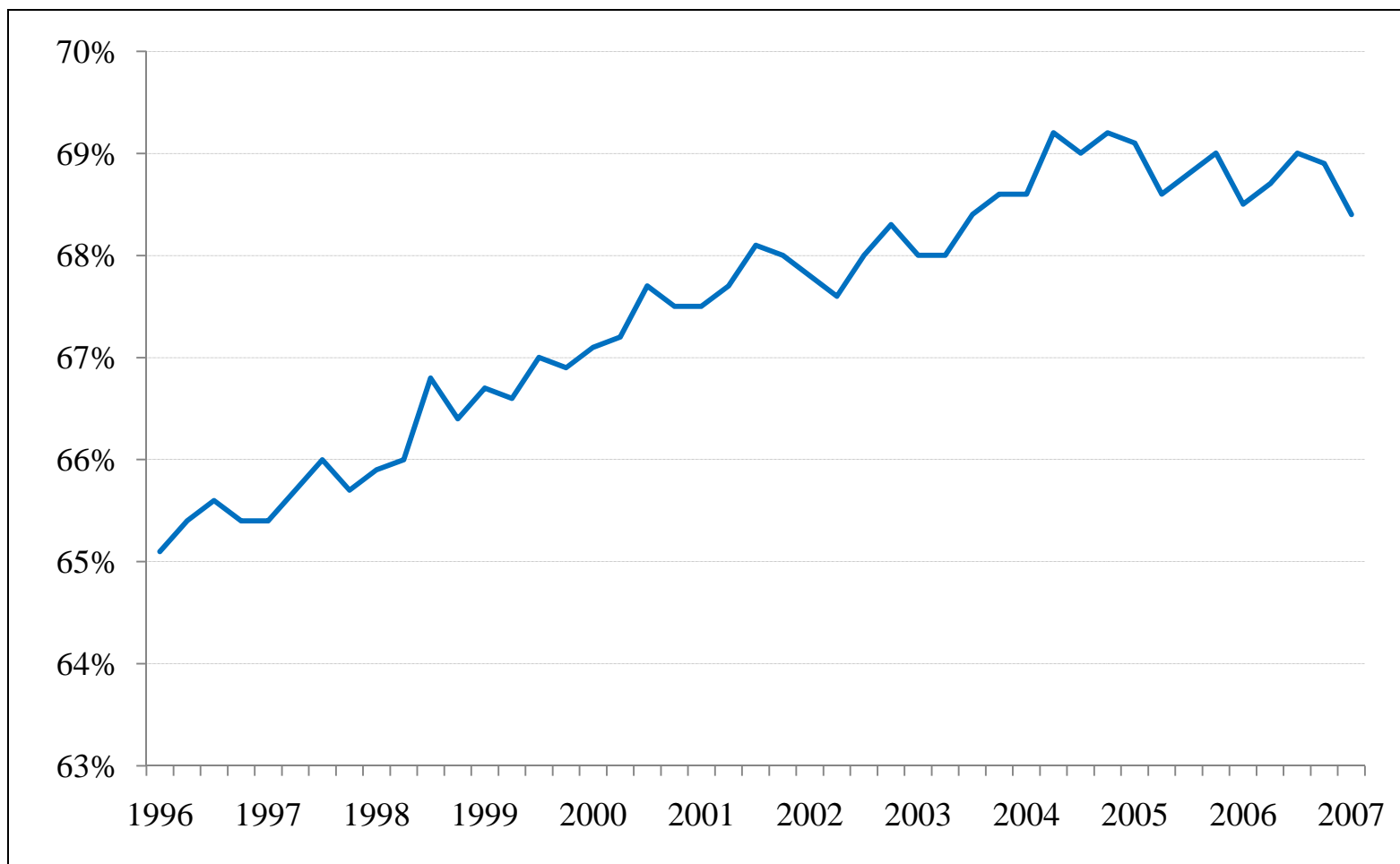
#### **New Home Sales (000s) and Average Sales Price**



Note: 2007 new homes sales are annualized year-to-date through August. 2007 average sales price is as of August.

Source: NAHB

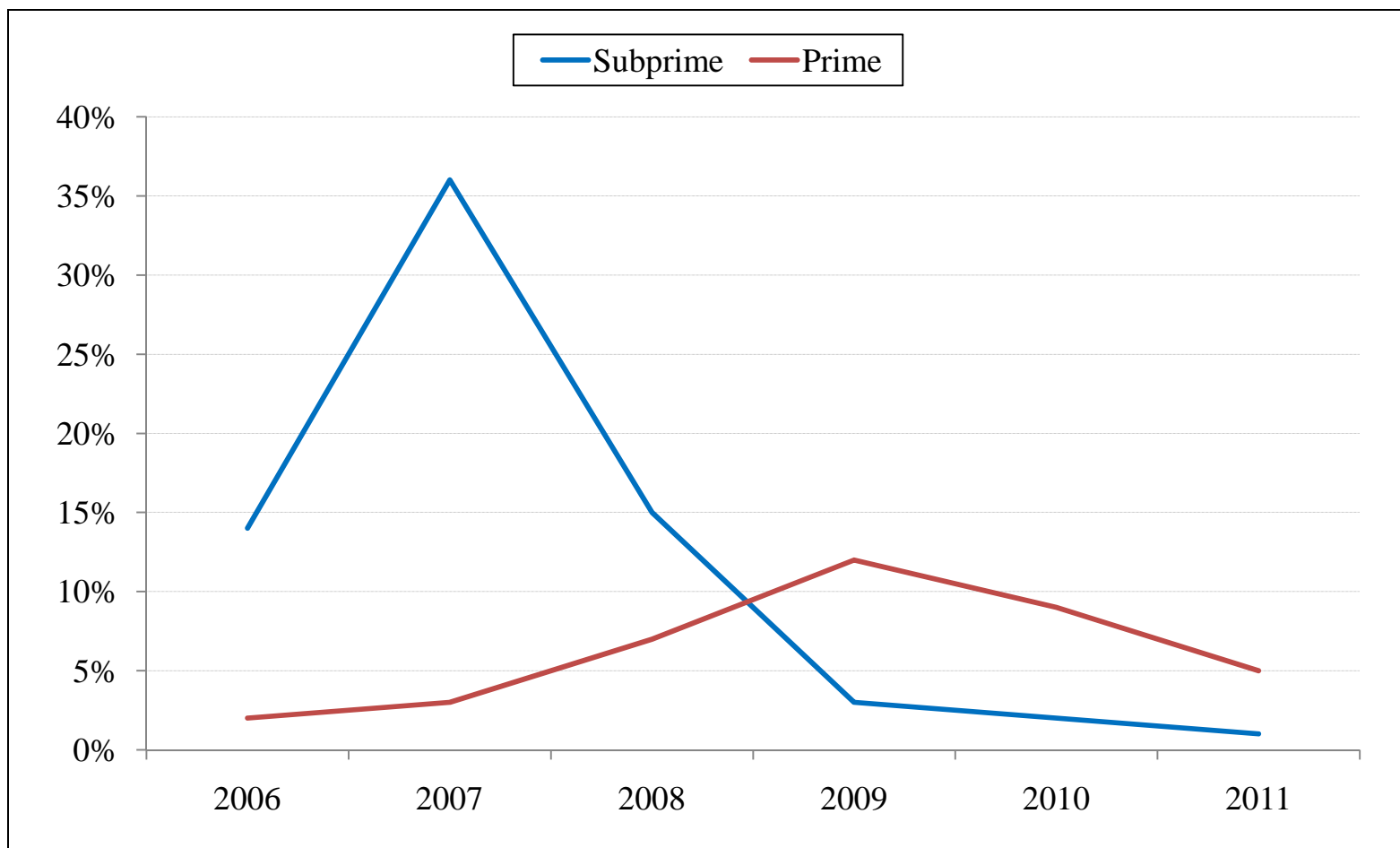
**Chart 4**  
**Homeownership Rate**



Source: Census Bureau

## **Chart 5**

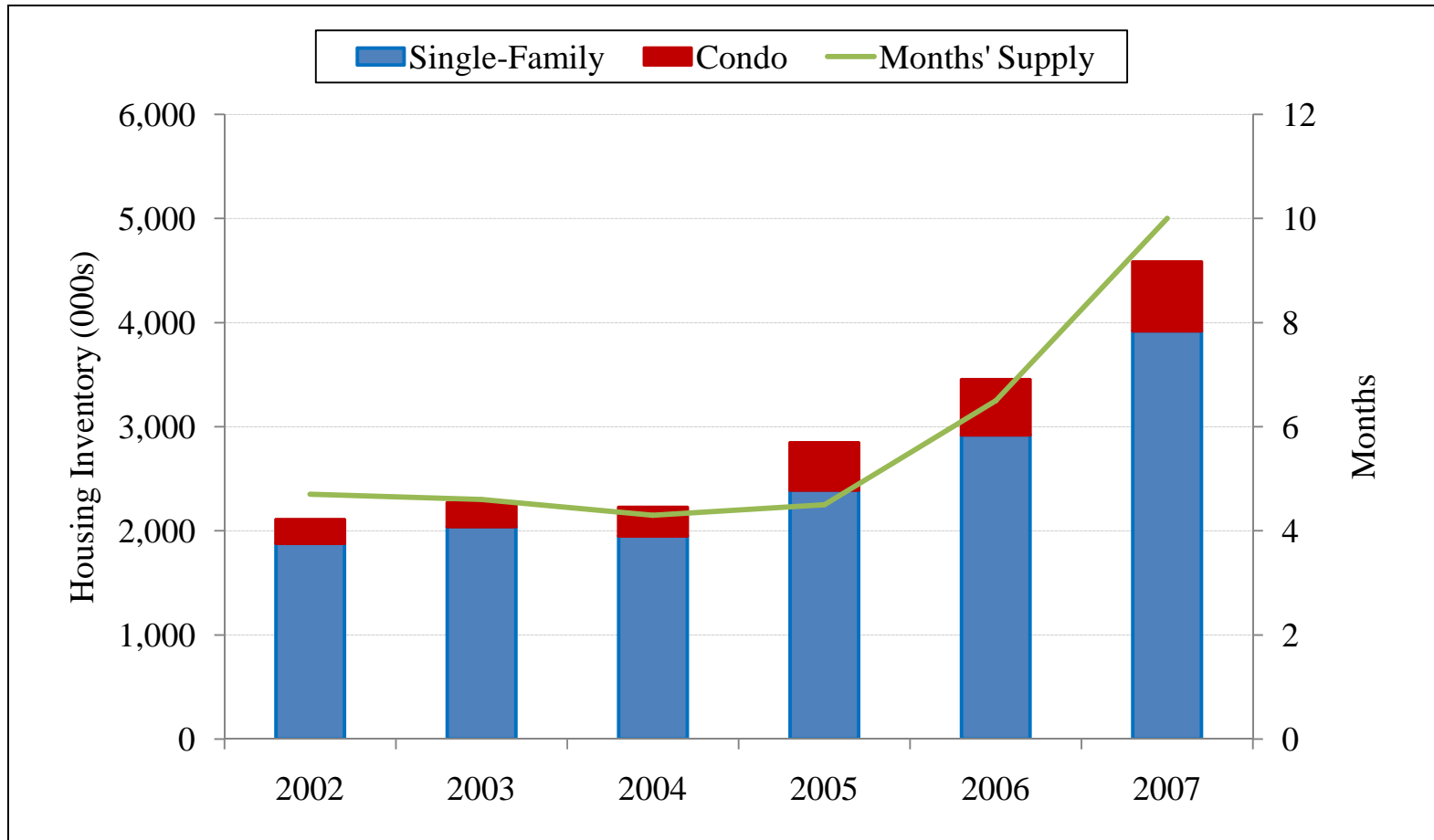
### **Year Outstanding Loans Are Scheduled to Adjust (% of Loans Outstanding)**



Source: Fitch Ratings

## **Chart 6**

### **Housing Inventory and Months' Supply of Inventory**



Note: 2007 figures annualized year-to-date through August

Source: NAHB

## **ALLAN I. MENDELOWITZ**

Allan I. Mendelowitz has served on the Board of Directors of the Federal Housing Finance Board (FHFB) since 2000.

Dr. Mendelowitz, who was born and raised in Middletown, Connecticut, was the Executive Director of the U.S. Trade Deficit Review Commission, a congressionally appointed, bi-partisan panel, from October of 1999 until his appointment as chairman of the Federal Housing Finance Board. Previously he served as the Executive Vice President of the Export-Import Bank of the United States where he was responsible for overseeing all Export-Import Bank programs and operations. Prior to that position, he was Managing Director for International Trade, Finance and Economic Competitiveness at the U.S. GAO, during which time he directed a large number of studies of the nation's international trade and finance programs and policies, and testified numerous times before committees of the Congress of the United States. Dr. Mendelowitz spent 1980 as the senior economist and representative of the Comptroller General with the Chrysler Corporation Loan Guarantee Board negotiating the terms of the Federal loan guarantee. Prior to joining the GAO he was an Economic Policy Fellow at the Brookings Institution and on the faculty of the Department of Economics of Rutgers University where he taught courses in urban and regional economics and international trade and finance.

Articles by Dr. Mendelowitz have appeared in the Journal of Business, the National Tax Journal, the Journal of Policy Analysis and Management, the Financial Times, and various conference proceedings' volumes.

Dr. Mendelowitz received an A.B. degree from Columbia University, and M.A. and Ph.D. degrees from Northwestern University. Dr. Mendelowitz and his wife, Shereen, currently reside in Rockville, Maryland, and have two adult children.