

## **The Housing Finance Revolution**

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## **I. Introduction**

Houses are expensive. Consequently, the availability and cost of housing finance are critical determinants of how well housing markets function around the world.

Changes in housing finance mechanisms are drivers in explaining the dramatic changes in housing markets and housing activity seen in industrialized countries in recent years. In many countries, historically, housing finance relied on funds provided by local lenders, typically depository institutions. With the development of capital markets and mortgage securitization, however, funding for housing comes from a much broader set of investors, including international investors. This paper examines the institutional changes in housing finance in industrialized countries over the past 30 years, including securitization and new types of mortgage contracts.

In several countries, most prominently the United States, there has been a major move to finance housing through mortgage back securities (MBS). The market structure that supports securitization as the predominant funding source for mortgage finance in the United States has changed dramatically over time. We describe these changes and the related developments of home equity extraction and borrowing, and credit scoring, and what has been behind these developments. We also consider how government policy and market forces have both contributed to these developments.

Housing finance systems have evolved differently across countries, although there are elements in common. National institutional factors remain important and the result is a variety in housing finance institutions. What accounts for these cross-country differences in the structure of housing finance? Is there a process of convergence in structure? And how have these changes affected housing affordability? We begin with an

international perspective examining these issues first broadly and then in the particular cases of Bangladesh, Korea, and Australia.

We then turn to the U.S. and consider how the assignment of risks associated with mortgage lending has changed as a result of recent housing finance innovation, while reflecting on new stress points and implications for financial stability. Finally we consider what, if any, are the implications for supervisory policies or financial market regulation.

## **II. The Housing Finance Revolution: A Global Perspective**

Over the past 30 years, housing finance systems in industrialized countries have undergone revolutionary change. Historically, housing finance has been provided by heavily regulated local lenders and by government run entities. Mortgage finance had not been funded by international capital flows. Today, integration of housing finance into capital markets is a global phenomenon, albeit in varied forms. The deregulation of housing finance and its integration into global financial markets is occurring throughout the world. Nonetheless the historical structures of housing finance have heavily impacted nation specific integration paradigms. Housing finance systems can be divided into four major types; these include: depository systems, directed credit (including provident funds, raised by payroll taxes, and contractual savings schemes), specialized mortgage banks (either government regulated or owned), and, more recently, secondary mortgage market systems.

The traditional methods of housing finance were constrained by government policies that segmented the financing of housing into specialized circuits that were cut off from the rest of the economy. Even the most market-oriented approach, which provided housing finance through a depository system, was heavily regulated through the 1980s. For example in the UK, housing finance in the early 1980s was largely funded by building societies that charged below-market interest rates. Building societies were formed by co-operatives that pooled savings to finance the purchase of homes. With lenders cooperating to set below-market rates on loans, the mortgage market was shielded from macroeconomic fluctuations, making them “intentionally unresponsive to market rate changes” (Diamond, 2003). Under these circumstances, institutions raising capital

through market channels, such as commercial banks, could not compete, and so mortgage financing largely rested in institutions shielded from market pressures.

The integration of housing finance into capital markets resulted from the deregulation of these cooperatives. The Building Society Act in 1986 resulted in these institutions offering competitive banking services equivalent to normal banks. Building Societies were allowed to convert to corporate status, operate as private firms and access capital markets via controlled public offerings of stock. The Act also made provisions to allow commercial banks to offer variable rate mortgage products to borrowers. The leveling of the playing field enabled the larger and more integrated commercial banks to increase their market share through issuance of variable rate mortgages. As a result, specialized building societies declined in the UK, and commercial banks grew: building societies had provided 70% of mortgage debt outstanding in 1980 and by 2000, they were providing less than 15% with commercial banks providing over 70% (cite).

Mortgage backed securities were also introduced in the latter half of the decade (a development first introduced in the United States). Securitization of mortgage pools have allowed some borrowers access to longer-term funds from investors. To date however, these funds supply only a small share of housing finance funding in the UK, and variable rate mortgages continue to predominate.

Within what was to become the Euro-currency market, mortgage finance institutions underwent even greater transformation, given their historically greater government involvement. . Directed credit supply contractual saving schemes and state regulated mortgage bank lending declined and was once again replaced by lending commercial banks. For example in Spain, until the mid 1980s, the Central Bank

controlled the housing finance system by setting savings and borrowing rates for local savings banks which were restricted to invest in public debt and mortgages. In addition to these, the government was the principal originator of mortgage loans. But beginning in the mid 1980s, the government lifted its regulations to allow commercial lending institutions to enter the market, raise funds through demand deposits, and offer variable rate mortgage loans. In addition, vehicles for securitization were developed, although as in the UK, these remained a limited source of funding.

Throughout Europe, similar changes were occurring. From heavily regulated and rationed systems, modern housing finance emerged with funding increasingly supplied through market-oriented commercial banks. Even in Germany, where prior to 1980 most funds had been provided by heavily regulated or state owned mortgage banks (cite), private sector (depository institutions although with a different menu of mortgage products as discussed below) predominated by 2000. The result has been the explosion of mortgage growth throughout Europe as shown in Exhibit 1, although in some countries the high growth rates reflect very low starting levels as seen in Exhibit 2.

Similar changes occurred throughout the industrialized world, in formerly socialist and to some degree in emerging economies as well. The changes that have transformed housing finance have been global in scale and are the result of global forces. These include: new technology, a societal-wide move from government regulation to a greater market orientation, and a World-wide decline in interest rates.

Technological innovation has proved instrumental in the changes that have swept housing finance. The development of money market funds eliminated the constraints of interest rate ceilings, providing an alternative investment vehicle largely grounded on

highly rated, short-term debt securities. As a liquid and highly stable investment, money market funds first came to speed in the early 1970s with the Reserve Fund in the United States. Such innovation was abetted by the dismantling of capital barriers that had once hindered cross border flows. The development of the Euro market accelerated cross border cash flows. Money flowed out from regulated institutions into the new, higher-yield money market accounts, diminishing the ability to rely on protected savings deposits to fund loan origination. This outflow occurred in episodes of disintermediation, which worsened over time. An important example of this was the Savings and Loan crisis in the US, about which we will say more below. Countries such as the United Kingdom, and elsewhere where variable rates predominated, avoided similar crises, but nonetheless, rate ceilings were unsustainable. In Europe, this same force similarly undermined contractual savings, whose low returns were easily beaten by money markets. The mortgage bank system in Germany, which provided long term mortgage financing through on the balance sheet “covered bonds,” was not directly affected by this change. Nonetheless, commercial banks in Germany also moved to increase their market share by offering an alternative to the covered-bond financed non-pre-payable mortgage, to the depository financed variable rate mortgage with the option to prepay.

Forces of deregulation operating throughout the world also contributed to the development of commercial banks as primary providers of housing finance globally. Governments increasingly recognized that markets could deliver financing with lower levels of rationing. A consensus developed that the most effective way to secure sustainable finance was to develop market-based systems linked to capital markets.

This did not necessarily imply securitization. Rather, commercial banks emerged as the major mortgage lenders in Europe and, as described elsewhere, in developed Asian economies as well.<sup>1</sup>

The third characteristic that allowed housing finance to become more linked to global capital markets is the major decline in interest rates worldwide. We show in Exhibit 3, average interest rates from 1980 to 2004 for 13 industrialized nations.<sup>2</sup> Nominal prime interest rates declined from an average of 15% in 1980 to 4.4% in 2004.<sup>3</sup> This historic decrease has been instrumental in achieving lower cost financing for mortgage lending in country after country, which adopted monetary policies to control inflation and to enable linkages to global capital flows. The unprecedented declines in the cost of market funding rewarded the move to market based financing. As examples we show how mortgage rates have declined with government debt yields in Exhibits 4 and 5 which track these series for the UK and France over the last 30 years.

The major consequence of the link to cheap debt provided by global capital flows is an increased access to financing for home ownership and a resulting increase in housing demand and surge in housing prices in industrialized economies throughout the world. Housing prices surged for three decades (through 2004). A sustained price increase of this sort across so many economies' housing markets, which are local markets, is highly unusual and perhaps unprecedented. While there are specific factors

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<sup>1</sup> See Kim (1997) for an excellent discussion of deregulation of housing and infrastructure finance in Asia.

<sup>2</sup> The countries covered are Spain (ES), Ireland (IE), the United Kingdom (UK), the Netherlands (NL), Belgium (BE), the United States (US), Japan (JP), France (FR), Canada (CA), Italy (IT), Australia (AU), Sweden (SE), and Germany (DE). The data on Korea is based on housing price index compiled by Kookmin Bank. Data are not available for all countries for all years. The source interest rate data is Economy.com and for price indexes is BIS (see Kim and Wachter, 2004).

<sup>3</sup> Interest rate declines have continued, across many economies, even with rising GDP growth rates in recent years. While declines in interest rates are to be expected with declining GDP growth rates of 2001, it is notable that the decline in rates continued even as world GDP growth resumed at high levels.

contributing to the run-up in individual countries, it is clear from the ubiquity of the price acceleration over the past two decades that global factors are at work.

The new factor is the translation of global interest rate declines into country specific mortgage rate declines. In the 1990's, the integration of previously segmented mortgage markets into global capital markets, allowed general interest rate declines to generate mortgage rate declines that both increased housing affordability and decreased the relative cost of housing.

Exhibit 6 presents simple regression results for six countries, testing for whether nominal interest rates Granger cause changes in house prices.<sup>4</sup> In all cases, the sign on the interest coefficient is negative, and in two cases, it is significant at the 95 percent confidence level. A pooled regression for the full set of countries shown in Exhibit 5 is significant at the 99 percent confidence level. While these are nothing more than stylized facts, they are also consistent with declining nominal interest rates driving house price appreciation. This points to a role for the erosion of rationing and lending constraints tied to high nominal rates. Interestingly, we could find no relationship between real interest rates and house prices.

Of course, supply elasticity is the key factor in housing price appreciation resulting from interest rate declines. While mortgage rate decreases improve affordability, housing asset price appreciation counter-balances this. While we have no direct data on supply constraints in Europe, it is notable that there are systematically higher rates of house price appreciation rates in cities (where supply of developable land is limited) relative to national rates of increase (Kim and Wachter 2004). There is also

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<sup>4</sup> The Granger tests are with one lag only, because we have small numbers of degrees of freedom.

evidence in the US that housing price increases occurred disproportionately on the two coasts, where supply is more limited<sup>5</sup>. Thus in the US mortgage rate declines have resulted in very different affordability outcomes across markets.

Housing is less affordable throughout the industrialized world than in most of the US<sup>6</sup>, and while mortgage rate declines (and increased access to mortgage financing) have increased affordability in many markets; elsewhere prices, in part due to other exogenous demand shifters, have increased more than interest rates have declined. This is, in part, due to the improved access to mortgages, which increases demand from segments of the population who previously did not have access to financing. Ireland stands as a prime example of this phenomenon (Second Annual Demographia International Housing Affordability 2006).

There is also the possibility that price acceleration, initiated by one-time mortgage market innovations that increase demand, may go beyond levels justified by fundamentals. If homeowners understand that declines in interest rates and mortgage innovation are one-time events, then the changes will lead to a stable and higher equilibrium house prices. However, if expectations about future house prices are based on observed ex post house price changes, bubbles can emerge (Malpezzi and Wachter, 2005, Case and Schiller 1989).

A second pervasive impact of the transformation of the provision of housing finance of the last 30 years is the current ubiquity of adjustable-rate mortgages (ARMs). Mortgages around the world range from short term, bullet loans due every three years, as

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<sup>5</sup> See Green, Malpezzi and Mayo (2005) and Glaeser, Gyourko and Saks (2005).

<sup>6</sup> Housing on the US coasts is expensive by World standards, but elsewhere in the US it is not.

in Korea, to the UK where upward increases are at the discretion of the banks, to Canada where mortgages rollover every five years and funding, but not interest rates, is guaranteed. Volatility concerns surrounding the use of variable rate mortgages have led to a movement by governments to implement the introduction and growth of securitization.<sup>7</sup> Securitization and the growth of market share for longer term fixed rate mortgages are being encouraged by government entities to mitigate exposure of households to interest rate risk and resulting house price and macroeconomic volatility. Nonetheless securitization has not been widely adopted and variable rate mortgages remain pervasive. As discussed below there may be little interest on the part of banks (cite) in raising capital to offer alternatives to the variable rate mortgage. Moreover, the current securitization related subprime crisis in the United States may raise doubts about the viability of housing finance systems grounded in securitization, as discussed further below.

To consider whether housing finance systems will converge to systems centered bank-funded ARM-lending or capital market based securitization backing longer-term mortgages, we examine in more detail the current transition from public sector and specialized housing financing institutions in several non-European countries. In the following we trace developments in three countries: Bangladesh, Korea, and Australia.

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<sup>7</sup> A report in the Daily Express this week revealed that **fixed rate mortgages will cost the average borrower at least £165 a month extra**. Gordon Brown cited **housing volatility as a key barrier to euro entry** in June in his five tests speech and announced a push towards fixed rate mortgages as an attempt to combat this volatility. The research in the Daily Express reveals however that fixed rate mortgages are unlikely to be popular. Simon Tyler of independent adviser Chase de Vere Mortgage Management, said “they (fixed rate mortgages) are never the cheapest deals on the market, so they will probably never be the most popular” (Daily Express, 18 November)

Even Bangladesh illustrates how mortgage markets are being transformed. Mortgage markets are still small there, but are increasingly relying on private sector institutions and privately held banks. In Korea, an economy that is now the tenth largest in the world, mortgages are currently funded almost entirely through private depository institutions that have evolved to replace government entities. These countries illustrate the most common evolving practice in both Asia and Europe of relying on depositories, instead of the securities market, for mortgage funding.

An exception is the Australian market, where securitization has become an important channel for mortgage finance. It remains an outlier, but provides an illustration of how a large asset-backed securities market can develop.

The outcome of these differing trends for global capital markets will be strongly impacted by the direction taken by the fast emerging economies of China and India. The shift from public intervention (in the form of state enterprises) to private finance in the mortgage market is being replicated in India and even more strongly in China. The shape their housing finance systems will take in turn will be influenced by developments elsewhere, particularly in Asia.

### **The Mortgage Revolution in Bangladesh**

Bangladesh has among the least sophisticated financial institutions of any country in the world. While it has a banking sector, it is only recently that private banks have developed; it also has nearly non-existent pensions and insurance sectors. Yet despite these primitive conditions, the housing finance sector in Bangladesh has changed

materially in the last five or six years, and those changes are consistent with those contemplated by the Washington Consensus.

For many years, the principal housing lender in Bangladesh was the Bangladesh Housing Building Finance Corporation (BHBFC), a government owned mortgage institution. As recently as 2001, nearly half the par value of mortgages in Bangladesh was held by BHBFC. The heavily subsidized institution did business outside the market, and as such has little incentive to make good lending decisions.

BHBFC was funded by the Bangladesh Treasury, with a cost of funds of five percent per year, an amount well below the market rate of interest. Mortgages were managed administratively, rather than financially: bureaucrats originated and serviced mortgages through rules (some formal, others not) instead of through market tested underwriting guidelines. This led to all manner of inefficiencies. First, BHBFC approval times were exceptionally long—sometimes as much as a year from application to approval. Second, because mortgages carried below market rates of interest, and were essentially granted by the government, they were allocated via rationing, rather than underwriting. The allocation process was often political, rather than financial. Third, because BHBFC was for many years not held to performance standards, the agency had little incentive to service loans, and so loan performance was poor. Typically, twenty percent of loans would be in arrears. When BHBFC did foreclose, it would typically collect less than 50 percent of the outstanding loan balance.

The most important thing the Bangladesh government did to begin the mortgage finance revolution in Bangladesh was to stop directly funding BHBFC. The corporation does retain a number of advantages—it gets a tax exemption, has much laxer capital

requirements than other financial institutions in Bangladesh, and has its bonds guaranteed by the national government. But since it has lost its direct government funding, its volume has stagnated, and its market share of mortgage debt outstanding dropped from 48 percent to 40 percent in just the period from 2001 to 2003.

About one-quarter of this loss of market share was filled by nationally owned banks, which had many of the same perverse incentives as BHBFC. But three-quarters of the change in market share was filled by private sector institutions, including privately held banks and private housing finance corporations.

What is remarkable is that these corporations (especially Delta BRACK housing finance and IDLC) were able to gain a toehold in the Bangladesh mortgage market despite a huge disadvantage in cost-of-funds. In June of 2003, public-sector financial institutions had a cost of funds of less than five percent, while private commercial banks had a cost of funds of nearly eight percent and housing finance corporations had a cost of funds of 12 percent. Yet the banks and the private HFCs were able to take business away from the government-owner institutions because they operated with far more efficiency. Delta BRACK and IDLC provide particularly interesting stories. Management at these institutions worked to develop underwriting standards for mortgages consistent with practices in the developed world. Borrowers are required to put substantial equity (typically 25 percent) into their houses, and need to meet payment ratio requirements. The HFCs also attempt to develop credit histories for their potential borrowers. They inferred from the experience of other countries that past history with bill-payment is a strong predictor of future payment.

HFCs also pay far more attention to servicing than their government counterparts; in particular, their management maintains that threatening to foreclose is an effective mechanism for getting borrowers to keep paying on time, or to redeem themselves quickly should they fall behind on their payments. Foreclosure laws in Bangladesh are rather weak, and it is questionable as to whether lenders would succeed to reclaiming property quickly and efficiently. Because of this, the HFCs do two things to protect their assets: they insist on holding titles until mortgages are retired, and they are aggressive about making borrowers aware when their payments are deficient.

While HFCs are still a small part of the housing finance system in Bangladesh, they are examples of the World-wide revolution in housing finance. They treat housing finance decisions as a business matter, rather than an administrative matter; they use an empirical foundation for making underwriting decisions, and they are as aggressive as possible about curing deficient loans. What is remarkable is that they are able to attract borrowers even though their cost of funds is substantially higher than their government-guaranteed competitors.

Executives from IDLC maintained in 2004<sup>8</sup> that lack of capital prevented more rapid growth, Bangladesh is hampered by a lack of long-term capital markets; the country does not have vehicles for long-term savings such as pension funds and life-insurance companies. At the same time, the banking system has until recently been entirely nationalized. So while Bangladesh has taken some important steps in redeveloping a more rationalized and efficient mortgage system, until financial institutions in general become more mature, there will be limits to how much housing finance can develop.

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<sup>8</sup> Green interviewed officers of both IDLC and BRACK while on a World Bank mission in May 2004.

## **The Mortgage Market in Korea**

While South Korea's economy grew rapidly between the end of the Korean War and the middle 1990s, the sophistication of its mortgage market did not. Overall, the mortgage market was largely in the hands of two government institutions: the Korea Housing Bank and the National Housing Fund.<sup>9</sup> Conventional depository institutions were not interested in holding mortgages, because the regulatory regime held mortgage interest rates below short-term market interest rates. On the other hand, households could only obtain mortgages if they placed deposits in one of the two housing institutions, both of which paid below market interest rates.

The upshot of this was stunted development of the Korean Mortgage Market. Borrowers had to wait their turn in a queue before becoming eligible to receive a very low loan-to-value ratio loan. This in turn led to a very low Mortgage Debt Outstanding to GDP ratio compared with other small—in the early 1990s, the ratio of the number of households to the number of housing units in Korea was roughly two-to-one.

The 1998 Asian Financial crisis gave the Korean government motivation to bring about reform,<sup>10</sup> including the development of a more market driven mortgage market. And as Bank of Korea data demonstrate, both the consumer credit market in general and the mortgage market in particular have grown quite rapidly in the aftermath of these reforms (see Exhibit 7).

But the Korean mortgage system now very much resembles the US system before the great depression. Loans generally have very low loan-to-value ratios, variable rates

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<sup>9</sup> See Renauld (1988) and Struyck and Turner (1986) for excellent descriptions of the Korean Housing Finance System.

<sup>10</sup> See Kim (2001).

of interest, and balloon payments. Mortgages in Korea are still financed almost entirely through depositories, rather than capital markets. Some policymakers in Korea believe that securitization is necessary for mortgages there to become more like their counterparts in other parts of the world. The Korean government has a set of schemes, such as KOMOCO, to securitize mortgages, and although there is growth recently in the use of longer-term mortgages backed by securitization, ARMs still predominate.

The various European mortgage systems, however, suggest that securitization is not the magic bullet for the creation of something viable. The two emblematic countries with robust but somewhat differing mortgage systems are Germany and the United Kingdom. The German system is funded both by commercial banks through deposits and by covered mortgage bonds directly funded via capital markets, with heavy restrictions on prepayment to limit the banks' interest rate risk<sup>11</sup>, and as we have seen the UK system is funded almost exclusively through deposits to banks. Both systems work, although the homeownership rate in the UK, at 68 percent, is substantially higher than it is in Germany, where it is 40 percent (International Union for Housing Finance, 2000).<sup>12</sup> Thus these are two models for a viable mortgage system, each with its risks. A third model with its own risks is to rely on securitization through collateralized MBS, as Korea has attempted and as Australia has accomplished, as discussed in the following.

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<sup>11</sup> Germany largely uses covered bonds to finance mortgages. The bonds are structured in such a way that they largely keep risk with borrowers: the mortgages funded by the bonds are tightly underwritten, and generally have substantial prepayment penalties.

<sup>12</sup> We don't want to make too much of this difference, as there are other profound differences between the two countries' housing markets. But the fact that the British system is funded by banks has not seemed to retard the access of homebuyers to reasonably priced mortgage capital.

## **The Australian asset-backed security market<sup>13</sup>**

The Australian asset-backed security (ABS) market has grown rapidly over the past decade, and is now one of the largest ABS markets in the world. As at March 2007, Australian entities' ABS outstandings amounted to \$215 billion, up from \$18 billion a decade earlier. Roughly \$138 billion of these ABS are issued in Australia, with the remaining \$77 billion issued offshore.<sup>14</sup>

ABS were first issued in Australia by the NSW and the Victorian government housing agencies in the mid 1980s. However, the ABS market really started to develop in 1994, when specialist mortgage lenders entered the Australian mortgage lending market. These lenders relied on RMBS, rather than deposits, to fund their housing loans. Four factors allowed specialist mortgage lenders to enter the Australian mortgage market:

First, in the early 1990s, banks' interest margins on housing loans were a very high 4¼ percentage points (see Exhibit 8). High interest margins and very low default rates meant that housing loans were very profitable.<sup>15</sup>

The bank bill rate, which is the benchmark interest rate for most floating rate bonds in Australia stabilized in the early to mid 1990s at an interest rate that was well below this housing rate (Exhibit 9). The decrease in the bank bill rate was largely due to the sharp fall in the inflation rate in Australia, and provided specialist mortgage lenders with stable and predictable funding costs.

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<sup>13</sup> The foundation of this material is discussion at the EASE NBER Conference, June 2007.

<sup>14</sup> ABS data are available from Reserve Bank of Australia *Bulletin* Table B19 Securitization Vehicles (<http://www.rba.gov.au/Statistics/Bulletin/index.html>)

<sup>15</sup> The negative interest margins in the late 1980s are partly explained by: housing interest rates being capped until 1986; and the Government's announcement in 1988 that statutory reserve requirements would be phased out, with the banks agreeing to the quid pro quo that the savings be translated into lower lending rates (Gizycki and Lowe (2000)).

Second, Australian and overseas banks that did not have large mortgage lending operations in Australia, were willing to provide specialist mortgage lenders with wholesale lending facilities and help them develop their securitization procedures.

Finally, Australia's managed funds industry was growing rapidly, mainly due to the introduction of compulsory superannuation in the late 1980s. These institutional investors had a healthy appetite for highly rated debt (including ABS).<sup>16</sup>

During the late 1990s, banks and other deposit taking institutions started to issue reasonable quantities RMBS. Regional banks, in particular, have significantly increased their issuance of RMBS because their housing lending has been growing rapidly, and securitization is a cost-effective source of funding.

### **ABS markets in Australia and Asia Compared**

In Australia, the securitization market developed within a year or two of it being profitable to issue ABS. The ABS market was developed by specialist mortgage lenders in conjunction with a few banks that did not have large mortgage lending operations in Australia. These entities were keen to exploit the supernormal profits that were being earned on housing loans.

ABS issuance is growing, although slowly, in many countries in Asia, off of a low base. Given government encouragement in many of these countries, the relevant question may be “why aren't Asian securitization markets growing more quickly” rather than “why did the securitization market develop in Australia.” Factors that may be inhibiting

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<sup>16</sup> Managed Funds data are available from Reserve Bank of Australia *Bulletin* Table B18 Managed Funds (<http://www.rba.gov.au/Statistics/Bulletin/index.html>)

growth in securitization in Asia include: ample liquidity and as a result relatively low interest margins on housing loans in the banking system of many countries; resistance on the part of domestic banks in other countries where interest margins are high; and a lack of good data on mortgage default and prepayment rates available to potential securitizing institutions, which inhibits their underwriting of ABS .. We turn to the US case, a country where the housing finance revolution has led to a predominant reliance on securitization.

### **III. The Mortgage Revolution in the US**

Home mortgages have become an increasingly large part of American household balance sheets. In 1949, mortgage debt was equal to 20 percent of total household income; by 1979, it had risen to 46 percent of income; by 2001, 73 percent of income (Bernstein et al.). Similarly, mortgage debt was 15 percent of household assets in 1949, but rose to 28 percent of household assets by 1979 and 41 percent of household assets by 2001.

This enormous growth of American home mortgages, as shown in Exhibit 10 (as a percentage of GDP), has been accompanied by a transformation in their form such that American mortgages are now distinctively different from mortgages in the rest of the world. In fact, Cho (2004) shows that the growth in Mortgage Debt Outstanding in the United States has closely tracked the mortgage market's increased reliance on securitization.

The structure of the modern American mortgage has changed substantially over time. The U.S. mortgage before the 1930s would be nearly unrecognizable today: it featured variable interest rates, high down-payments, and short maturities. In fact, before the Great Depression, homeowners typically renegotiated their loans every year.

The ignition of inflation in the later 1960s and 1970s altered the ability of depositories to fund long-term, fixed-rate mortgages: inflation pushed up nominal interest rates and eroded the balance sheets of depositories that funded fixed-rate mortgages. Depositories found themselves in a straitjacket due to Regulation Q, a federal rule that placed a ceiling on the rate that depositories could pay depositors. As nominal interest rates rose, depositories could not match what the market was paying, and they saw

deposits flow out their doors to U.S. Treasury securities—assets back by the full faith and credit of the United States that paid a market rate of interest. A second factor, operating in the US, as well as elsewhere, in limiting the ability of depositories to fund fixed-rate mortgages was the rise of new competing savings vehicles, such as money market funds, mutual funds and pension funds, which paid higher rates than depositories and which became accessible to small savers. At the same time, long-term savings vehicles, such as pension funds, were better suited for investment in long-term assets, such as securitized long-term mortgages.

The result of the ignition of inflation and the new savings vehicles was an outflow of funds. This led to a crisis in the savings and loan industry, a major structural change in U.S. mortgage markets, and ultimately a transformation of the housing finance system.<sup>17</sup> Legislation did respond to the new environment, and removed deposit ceilings and allowed thrifts to invest in adjustable rate mortgages.<sup>18</sup>

For a time in the late 1970s and early 1980s, when many pundits were projecting massive and variable inflation for years to come, it even appeared that the fixed rate mortgage might become an historical anomaly, and that the U.S. mortgage market would return to the adjustable rate mortgages that had been common before the 1930s. In a highly volatile inflationary context, fixed rate mortgages become exorbitantly costly, effectively eliminating their market (see Exhibit 11).

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<sup>17</sup> Commercial banking industry was not nearly as affected since, unlike S&Ls which by statute invested in mortgages, banks were able to invest in a variety of assets. For a discussion of the S&L crisis and its aftermath, see Bentson and Kaufman (1997).

<sup>18</sup> The legislation that allowed adjustable rate mortgages and eliminated interest rate ceilings for S&L banks was the St. Germain Depository Institutions Act of 1982. Specifically, Title VIII- the “Alternative Mortgage Transaction Parity Act of 1982” Sec.803 (A) “in which the interest rate or finance charge may be adjusted or renegotiated.”

## **The First US Mortgage Revolution**

One cannot grasp the modern housing finance revolution without considering the revolution of the 1930s—the revolution in which the long-term, self-amortizing, fixed rate mortgage was born.

Before 1933, the typical first-lien mortgage in the United States had a short-term, a variable rate of interest, and a loan-to-value ratio of 50 percent or less. Mortgages usually had no amortization, and consequently required a balloon payment at the end of the mortgage term, which was usually something less than five years. Mortgages were funded by two types of lenders: Savings and Loans, which were local mutual, depository institutions, and mortgage bankers, who acted as brokers between borrowers and investors such as insurance companies. In the 19<sup>th</sup> century, loans were often funded by life-insurance companies, and for some insurance companies, such as Northwest Mutual Life Insurance, farm and home mortgages were the principal repository for investment<sup>19</sup>.

Lenders set mortgage terms to insulate themselves from risk. The variable interest rate protected depository institutions from fluctuations in interest rates, and the low loan-to-value ratios protected them from credit risk. But the bullet payment feature created a problem when unemployment rose and bank liquidity fell during the Great Depression. As Bernanke and Gertler (1989) note, periods of price deflation, such as the Great Depression, create particular problems for debt holders, as interest rates cannot fall below zero. At the time mortgages came due in the early 1930s, real interest rates were very high, which exacerbated the fall in house prices. At the same time, the nominal

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<sup>19</sup> This statement is based on a conversation with Eugene Skaggs, who was Executive Vice President for equity investment for the Northwest Mutual Life Insurance Company.

value of outstanding debt remained unchanged, so loan-to-value ratios effectively rose. This led financial institutions to avoid extending credit to borrower who wished to refinance. Borrowers therefore had to sell their houses to pay off their mortgages, which led to a flood of houses on the market, which further depressed prices. Borrowers who couldn't sell defaulted, lenders foreclosed, and then sought to sell in order to raise liquidity. This weakened the market even further.

To restore liquidity to the mortgage market, New Deal Housing Finance legislation created the Federal Housing Administration to insure long-term mortgages, and the Home Owners Loan Corporation (and its successor, the Federal National Mortgage Association) to tie the mortgage markets to capital markets. Green (2007) notes:

The HOLC, backed with the full faith and credit of the US Government, raised money in the bond market to purchase non-performing mortgages from depository institutions. They reinstated the loans as 20 year fixed payment mortgages (Green and Wachter 2005). One could look at this as the first example of mass “loan modification.” Borrowers were relieved from an impossible position (where they had to raise a large amount of cash to pay off a mortgage balance) and placed in a manageable position. At the same time, by changing the terms of the loans, the federal government reduced the risk embedded in them, and therefore increased their value to depositories<sup>20</sup>, who ultimately bought them back from the HOLC.

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<sup>20</sup> Particularly since they were insured by the Federal Housing Administration.

While the government's intervention in the credit market was successful, one could also argue that the success arose in part from extraordinarily good timing. FHA was created *after* the housing market had cratered, and after the general price level had fallen about as much as it was going to fall. BLS data (2007) report that the Consumer Price Index fell by 22.8 percent between January 1930 and January 1934, but rose by 7.5 percent between January 1934 and 1938.

Nevertheless, New Deal housing finance legislation created two important precedents: the direct intervention of the federal government in the US housing finance market, and the creation within the United States of long-term, self-amortizing, fixed-rate mortgages with relatively high loan-to-value ratios.

## **Antecedents and Fomenters of the Current Mortgage Revolution**

### *Market Conditions*

The “first” modern mortgage system in the United States lasted from the New Deal era through the 1970s. Under this system, the principal source of mortgage finance was local Savings and Loans; during the 1970s, more than half of home mortgage debt outstanding was held by Savings and Loans (see Exhibit 12).

These institutions were heavily regulated and federally insured. An S&L's assets were restricted largely to home mortgage on properties within a fifty mile radius of the institution. The geographical limitation was supposed to insure that lenders had “local expertise” in underwriting mortgages. More generally, mortgage underwriting was based at least in part on relationships, and as such was quite different from the empirically based metrics that are the foundation of prime mortgage underwriting today.

Its liabilities were deposits whose interest rates were limited by a ceiling extended to Savings and Loans in 1966 and removed in 1986 the Monetary Control Act of 1980. Depositors were protected by the full faith and credit of the United States Government through the Federal Savings and Loan Insurance Corporation.<sup>21</sup> Finally, S&Ls could receive advances from a Federal Home Loan Bank at below market rates of interest to finance mortgages. They were required to hold regulatory capital of five percent, although the definition of capital was not particularly rigorous. Federal Government supervisory staff for Savings and Loans was fairly small and poorly paid, so that competent examiners would move from S&L supervision to bank supervision, where work was more interesting and pay was better.

Before the late 1960s, the S&L system worked quite well for the United States. While supervision was lax, the inability of Savings and Loans to do anything other than make mortgage loans largely prevented moral hazard. The S&L Charter also gave S&L management a franchise worth protecting—the ability to borrow at below market interest rates<sup>22</sup> to fund market rate mortgages. This meant that Savings and Loans were steadily, if not spectacularly, profitable.

Favorable macroeconomic conditions helped the system work. Nominal interest rates remained low, and perhaps just as important, the yield curve sloped upward at almost all times before 1966 (see Exhibit 13). Before the 1980s, mortgages were overwhelmingly long-term fixed-rate products, subject to substantial interest rate risk. As Fisher and Van Order (2006) put it, “the institutions were not allowed to originate

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<sup>21</sup> Deposits initially insured up to \$2500; they are now insured up to \$100,000.

<sup>22</sup> Thanks to both FSLIC and the Federal Home Loan Bank system.

“balloon” mortgages, which had caused the Depression-era wave of foreclosures.

Through its underwriting standards for the provision of mortgage insurance, the Federal Housing Administration (FHA) made the long-term fully amortizing loan with a fixed rate of interest (FRM) ubiquitous in the U.S. starting in the 1930s.” As we shall discuss later, the regulatory climate was at least partially responsible for this ubiquity.

So long as interest rates remained stable (and so long as the yield-curve remained positively sloped), interest rate risk had little impact on profitability—or at least on solvency. But a hint of problems to come arose in 1966, when the yield curve turned and remained negatively sloped for more than a year (specifically December 1965 through February 1967). During this time, some Savings and Loans became insolvent, and all faced dis-intermediation problems. Changing macroeconomic conditions revealed an unsustainable regulatory regime.

In 1968 Fannie Mae was divided into two pieces: the Government National Mortgage Association, known as Ginnie Mae, and the “new” Fannie Mae, which would now be privately held and would be able to buy and sell non-government backed mortgages to raise additional funds for mortgages. Congress’ intent with the creation of Ginnie, the new Fannie, and Freddie Mac (which was created in 1970 to assure Savings and Loans always had adequate liquidity) was at least in part to assure that the mortgage liquidity problems of 1966 would never happen again. The federal charters that were granted to Fannie and Freddie in fact require them to promote liquidity and stability in the secondary market for mortgages as well as to provide mortgage credit throughout the nation. These institutions would in turn bring uniformity to the mortgage market and

invent financial instruments –derivatives of mortgage backed securities—that would help keep the mortgage market liquid for the entire period from the middle 1980s until today.

At the same time, some Savings and Loans attempted to deal with the problem by issuing adjustable rate mortgages, and by 1969, around 19 percent of new mortgages did have floating rates. It was not actually clear, however, whether Savings and Loans were permitted to make such loans. The Federal Home Loan Bank didn't believe that they did, and so promulgated a rule that prevented payments from ever rising over the life of a loan (Fisher and Van Order 2006).

By effectively barring ARMS, the Federal Home Loan Bank Board prevented Savings and Loans from managing market risk, and removed incentives to learn more sophisticated balance sheet management.

The problems of the 1960s were minor when compared with the late 1970s. Double-digit inflation produced double digit long-term interest rates; recessionary expectations led to a sharply negative yield curve. Savings and Loans became substantially insolvent. In an environment in which the one-year Treasury rate rose to 15.06 percent, the present value of a mortgage with a seven percent coupon rate and a ten-year expected life fell to 28 percent less than par. The minimum capital requirement for Savings and Loans was only five percent, and the institutions were required to invest almost exclusively in long-term fixed rate mortgages.

Beyond the problem of interest rate risk, Savings and Loans in the late 1970s faced credit risk for the first time. Between the end of World War II and the 1970s, house prices in the United States rose in almost all years in almost all places. Conventional loans had credit enhancements (either relatively low loan-to-value ratios or

private mortgage insurance), and FHA loans were backed by the full faith and credit of the US Government. This meant that residential mortgages were very safe, as equity or insurance protected against default loss.

The early 1980s, however, brought about nominal house price declines in the rust belt. OFHEO data show that house prices 1982 in Detroit fell by 17 percent, in Flint by 15 percent. Prices in Cleveland fell by a small amount over the course of 1982, but nominal prices didn't go up much either between 1980 and 1984, meaning that borrowers accrued little equity just by sitting in their houses.

Defaults rose substantially. Savings and Loans were prevented from lending beyond a very limited geographical area, meaning that they were unable to diversify geographically. This combination of events produced a broken housing finance system. Mortgage debt outstanding relative to personal income fell by 7 percent between 1979 and 1981. In the face of this, lenders and government officials recognized a need to change mortgage loan procedures. While part of the "solution" to the mortgage finance crisis was the catastrophically awful Garn-St. Germain Act of 1982, part of it was the development of a revolution that still reverberates.

Specifically, Congress recognized that ceilings on returns to deposits were counterproductive, and passed the Monetary Control Act of 1980 phasing out Regulation Q. Moreover, the Federal Home Loan Bank Board recognized that depositories could protect themselves against interest rate risk by issuing Adjustable Rate Mortgages. The Federal Home Loan Bank Board in 1982 gave explicit permission for Savings and Loans to originate and hold ARMs, and the market share of ARMs responded accordingly.

While other countries dismantled their segmented housing finance systems and linked housing finance to capital markets through deregulated depositories, the US linked housing finance to capital markets through depository deregulation and securitization.

Thrifts restructured their portfolios by exchanging fixed rate mortgages for MBS that could be sold to one of the US secondary market agencies. This behavior was encouraged by rules that allowed losses to be amortized rather than realized immediately (Wachter, 1990). Thrifts then solved their asset liability mismatch going forward by holding in their portfolios newly available adjustable rate mortgages.

Elsewhere securitization has not developed in part because the “infrastructure requirements for mortgage security issuance are demanding, time consuming, and costly” (Chiquier, Hassler, and Lea 2004). The US on the other hand provided the underpinnings for its mortgage security infrastructure with the creation of HOLC in 1934 and FNMA in 1938. Freddie Mac invented MBS pass-throughs in 1971. The mortgage securities market became increasingly sophisticated as it integrated the tools of modern finance, as discussed further below.

One of the mechanisms the GSEs used to create liquidity in the mortgage market was the standardization of mortgage documentation. This documentation allowed the GSEs to collect parsimoniously the data necessary to develop robust underwriting models and guaranteed that home mortgages within securities would be sufficiently homogeneous that they could trade in liquid markets.

These developments allowed 22 years of uninterrupted liquidity in the market for conventional conforming mortgages.<sup>23</sup>

### *State of Knowledge*

So far as we know, no one applied option pricing theory to mortgages before the late 1970s, when Asay (1978) wrote an innovative and seminal dissertation. Dunn and McConnell (1981) and Foster and Van Order (1984) followed with influential papers of their own. Yet on reflection, mortgages obviously have lots of optionality embedded in them. Borrowers have an option to put houses back to lenders through default, and an option to call mortgages back from lenders through low-cost refinancing. Black-Scholes modeling techniques thus helped investor gain insights into the spreads they required in order to be compensated for underlying mortgage risk.

The mortgage market made for a particularly interesting application of option pricing theory because borrowers often do not exercise optimally. While the frequency of the exercise of both the call and put options increases as they get deeper and deeper into the money (Foster and Van Order 1984 and 1985, Kau, Keenan and Kim 1993), households do not appear to default ruthlessly nor prepay optimally. With respect to default, many households seemed particularly immune to market conditions. Foster and Van Order found that of households whose mortgage debt exceeded 110 percent of house value, only around four percent defaulted.

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<sup>23</sup> Conventional mortgages are those not backed by the full faith and credit of the US government. Conforming mortgages are those eligible for purchase by Fannie Mae and Freddie Mac.

Ling and Archer (1993) and Green and Lacour-Little (1999) also found that households did not exercise prepayment optimally. In fact, in the middle 1990s, many borrowers had mortgages whose coupon rates were more than 200 basis points above market rates, and yet failed to refinance. Identifying such borrowers became an important part of mortgage pricing, because slow prepaying, premium mortgages were highly profitable. So as mortgages began to be funded increasingly in capital markets, and as computer power became cheaper, investors in mortgages developed sophisticated models of default and prepayment behavior.

Residential borrowers do not (or at least did not) behave in the same manner as corporate borrowers, and indeed, may not behave in a manner easily explicable by any theory of utility maximization.<sup>24</sup> Thus, investors that could identify the characteristics of borrowers who did not behave “optimally” gained a considerable advantage over others.

Changing behavior and changing loan origination costs have, however, undermined the ability of econometric models to predict prepayment speeds. Borrowers have become much more aggressive in the exercise of the call option. Bloomberg data show that The Public Securities Administration Conditional Prepayment Rates (CPR) for a mortgage with a 100 basis point spread over market has increased by three-to-four times between 1993 and 2006. In 2005, when mortgage interest rates were low, around 40 percent of existing mortgages were refinanced in a single year. The instability of models predicting prepayment may be a harbinger about how much we can glean about future defaults based on past default models.

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<sup>24</sup> Kau, Keenan and Kim (1994) dispute this, arguing that both rational and “irrational” behavior could be observationally equivalent to each other.

## **The Succession to the Revolution: The Terror?**

A variety of indicators imply that the housing finance revolution in the US has improved efficiency and consumer welfare. Nevertheless, recent events suggest that, just as in 1789, a revolution has produced a terror.

An important precursor to the subprime crisis was the development of the private label MBS market for non-conforming prime mortgages. This market developed in parallel with the Fannie/Freddie security structure, and allowed for capital market financing of mortgages whose balances were larger than that permitted for Fannie/Freddie purchase.<sup>25</sup> The private-label market worked to support growth of securitization of “jumbo” mortgages as the Fannie/Freddie agency debt supported the growth of prime mortgages, although it was in a few ways critically different from the agency market.

Because private-label securities have no government backing, implicit or otherwise, the coupon rates on loans backed by such securities are a bit higher than they are in the conforming market. The Congressional Budget Office (2004) estimates that borrowers in the non-conforming market pay a premium of 25 basis points relative to borrowers in the conforming market. Green and Wachter (2005) note that non-conforming mortgages typically have higher down-payments and a greater tendency to be ARMs than conforming mortgages, but that could be a result of borrower choice, rather than security structure.

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<sup>25</sup> Every year, the Office of Federal Housing Enterprise Oversight uses a formula based on house prices to determine the maximum-sized loan that Fannie Mae and Freddie Mac may purchase. This is known as the “conforming loan limit.”

The most meaningful way in which private label securities differ from agency-backed securities is with respect to structure. Fannie and Freddie securities are tranced for prepayment risk, but are generally not tranced for credit risk. Private label securities are, however, tranced for credit risk. As a result, early tranches are presumed to have virtually no credit risk (particularly in the prime market for jumbo loans), while later tranches take on more credit risk, and therefore earn higher expected rates of return. Over the period of the later 1990s, when house prices were rising and the private label market was largely confined to prime mortgages, credit losses on even junior tranches remained low.

This all changed recently. The private label market grew dramatically, with issuances rising from from \$586 billion in 2003 to \$1.2 trillion in 2005. A large share of the growth came from the subprime and Alt-A markets<sup>26</sup>, whose share of the private label market grew from 41 percent to 76 percent over this two-year period (England 2006).

The creation of structured finance for mortgage credit risk abetted the rise of the subprime market. For a time, capital markets seemed to have an appetite for almost any kind of risk, so long as it received sufficiently large yield in exchange. But as we shall discuss below, investors in junior credit tranches were often facing uncertainty, rather than risk. Many subprime loans had essentially no underwriting, and insufficient data were available to calibrate default risk for subprime mortgages.

At the heart of the subprime crisis are three basic issues: pricing vs. rationing, asymmetric information between lender and borrowers, and asymmetric information

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<sup>26</sup> Alt-A loans are those whose credit characteristics fall in between prime and subprime mortgages.

between originators and investors. While the subprime crisis is too recent to develop formal empirical tests of its causes, we may list a set of candidates.

*Pricing vs. rationing*

One of the truly astonishing transformations of the mortgage market has been the increase in the access to mortgage credit. American Housing Survey data show that between 1997 and 2005, the number of households with a mortgage increased by 20 percent, while number of households increased by nine percent. Nominal mortgage debt outstanding grew by 2.5 times over that time period<sup>27</sup>, while nominal GDP grew by 50 percent.

This market growth was in part a function in part of more efficient average cost pricing of credit or “rationing:” prime mortgages are now usually underwritten with logit models, and borrowers are either accepted or rejected based on these logits. Those accepted into the pool pay the same average-cost price, except that those with loan-to-value ratios in excess of 80 percent must pay mortgage insurance premiums. The companies developing these models—Fannie Mae, Freddie Mac, Wells-Fargo, Citibank, etc.—hire sophisticated econometric modelers and have millions of observations with which to work. Consequently, they estimate models with precise coefficient estimates and small residuals. These well-estimated models mitigate against adverse selection among the pool of borrowers who are deemed to be good credit risks. Indeed, econometric underwriting models have shown that two observables—loan-to-value ratio and credit history--have enormous power in predicting default risk. Lenders have also used automation to assure the integrity of both of these measures. Automated valuation

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<sup>27</sup> *Federal Reserve Bulletin*, Table 1.54.

models (following the pioneering repeat sales techniques of Muth (1961) and Case and Shiller 1989) keep appraisers honest, while attempted tinkering with Fair-Isaac Credit Scores leads to a reduction in those scores.

As models have gotten more precise, more borrowers have become eligible to receive prime mortgages. Certain potential borrowers, however, do not qualify for prime mortgages, usually because of poor credit history. And so as these borrowers have been rationed out of the prime market, lenders have used pricing to bring them into the subprime market. Subprime originations increased from 8 percent of new loans in 2003 to 22 percent in 2005 (England 2006). Chairman Greenspan praised this development, noting:

“where once marginal applicants would have simply been denied credit, lenders are now able to quite efficiently judge the risk posed by individuals and price that risk appropriately...

...Improved access to credit for consumers, and especially these more-recent developments, has had significant benefits. Unquestionably, innovation and deregulation have vastly expanded credit availability to virtually all income classes. Access to credit has enabled families to purchase homes, deal with emergencies, and obtain goods and services. Home ownership is at a record high, and the number of home mortgage loans to low- and moderate-income and minority families has risen rapidly over the past five years. Credit cards and installment loans are also available to the vast majority of households.”<sup>28</sup>

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<sup>28</sup> See Remarks by Chairman Alan Greenspan at the Federal Reserve System’s Fourth Annual Community Affairs Research Conference, Washington, D.C., April 8, 2005. The ellipse is used for brevity: the remarks

Risk based pricing became widespread in the subprime market in the late 1990s along with the development of private label securitization of non-conventional mortgages. But while the algorithms for rationing credit became sophisticated, the algorithms for pricing subprime mortgages (to the extent such things even exist) faced a serious identification problem. From the period 1997 to 2005, the period in which the subprime market grew dramatically, nominal house prices in the United States rose rapidly and nearly ubiquitously. This meant that the incentive to default was extremely low—households had a strong incentive to sell their houses and preserve their equity rather than default.

At the same time, the subprime market developed new products whose features had never faced a market test. In particular, lenders introduced 2/28 and 3/27 Adjustable Rate Mortgages with prepayment penalties. These mortgages would have introductory teaser rates (for two or three years) that would reset to LIBOR or one-year Treasuries with a large spread. Borrowers would qualify for the loan based on the initial teaser rate, and then would be locked into the higher rate after the teaser expired.

Past research on teaser-rate ARMS originated in the 1980s showed that borrowers had a strong propensity to prepay when rates adjusted to a market rate of interest plus a large margin (see Green and Shilling 1997). Those ARMS did not have prepayment penalties, but they did suggest that borrowers as a group understood the product they were getting themselves into: they would take advantage of the teaser and then exit the mortgage once at the moment it would become profitable for the lender.

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within the ellipse emphasize that consumer worries about the use of technology for underwriting are largely misplaced. Available at <http://www.federalreserve.gov/boarddocs/speeches/2005/20050408/default.htm>.

Default is a much more serious credit event than prepayment, yet it should not be too surprising that borrowers would react to a payment shock. Indeed, originating this kind of mortgage almost is asking for adverse selection: for example, the rational borrower who uses a 2/28 will take advantage of the ability to live in a house at a below market rate of interest for two years, and will then observe the present value of the mortgage relative to the present value of the house at that point. Because the mortgage carries a premium interest rate (i.e., a rate whose foundation is a large spread over some benchmark), the chances are that the value from the borrower's perspective will be greater than the value of the asset, and so there will be an incentive to default. Once good data are available, it will be useful to observe whether 2/28 borrowers—or borrowers of negative amortization and optional payment ARMS--default more ruthlessly than others. As it is, we know from Federal Reserve Data that almost all of the subprime delinquency problems arise from adjustable rate mortgages.

But let us return to the point. The lending industry attempted to reach out to borrowers not served by the prime market through pricing. The apparent mistake the industry made was to offer a loss-leader price in the early years of a loan in order to get borrowers into the market, in the hope that they would make up the difference in later years. They attempted to enforce the higher price in the future through use of prepayment penalties. Prima facie evidence suggests that this did not work.

#### *Asymmetric Information and Adverse Selection: Borrowers and Lenders*

Asymmetric information also arises because it is likely that mortgage originators understand mortgage pricing and risk better than borrowers. To make this concrete,

consider the nature of mortgage disclosures. The Fair Credit Reporting Act requires that borrowers be informed of the Annual Percentage Rate (APR) on their mortgage. The APR rate is the internal rate of return on a mortgage based on its coupon rate, discount points, amortization and term. APR assumes that borrowers never refinance, and makes no provision for fees other than discount points. As such, it does not give an accurate picture of mortgage cost.

Both borrower and investors in mortgages are interested in yield, which is the internal rate of return on a mortgage. But of course the yield is *not* the same thing as the mortgage coupon rate (the basis on which the mortgage amortizes) or the Annual Percentage Rate (APR) (a rate that amortizes the cost of discount points over the amortization period of the mortgage). The yield is rather the true return/cost of a mortgage. Even in the context of a fixed rate mortgage, disclosing effective cost is not straightforward.

Yield comes from six components: the note or coupon rate, discount points (up-front cash a borrowers pays to lower the coupon rate), fees, prepayment penalties, the life of the mortgage (i.e., how long the borrower actually pays the mortgage before refinancing or selling it off), and frequency of amortization.

To give a sense of how these things interact, consider three fairly simple mortgages. Mortgage one has a six percent fixed rate, no points, no fees, 30-year amortization and an expected life of three years. Mortgage two has a 4.5 percent fixed rate, two points, two percent fees, a two percent prepayment penalty if prepaid within five years, 30-year amortization and an expected life of three years. Mortgage three is the same as mortgage two, except that has an expected life of ten years. The regulatory

Annual Percentage Rate for the three mortgages is 6.16 percent, 4.86 percent and 4.86 percent respectively.<sup>29</sup>

But these APR calculations do not reflect the true cost of the mortgages (nor, obviously, do the coupon rates). The true cost of the mortgage is a function of how the borrower behaves after the mortgage is originated. The borrower of mortgage two decides to repay the mortgage after three years. This means that little time has passed to amortize points and fees, and that the borrower is subject to a prepayment penalty. As a consequence, while both the coupon and the APR on this mortgage are lower than the first mortgage, the actual cost to the borrower of the second mortgage, at 6.6 percent, is higher than the cost of the first mortgage, at 6.16 percent

Now let us consider the third mortgage. The borrower pays off this mortgage in ten years; consequently, enough time passes to substantially amortize the upfront mortgage costs, and to eliminate the prepayment penalty. As a consequence, the cost of this mortgage to the borrower (4.86 percent) is substantially lower than the cost of the first mortgage.

The point of this illustration is to show that it is difficult to characterize exactly what a mortgage price is, and that the price is driven in part by the behavior of the borrower after the loan is originated.

Price revelation is elusive for sub-prime borrowers (Wachter 2003). This is exacerbated by a lack of a guarantee of pricing at closing of all the terms, which adds complexity and reduces transparency. This means even under the best of circumstances,

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<sup>29</sup> APR assumes that discount points are amortized over the term of the loan. Fees and prepayment penalties are not included in APR.

disclosing true costs and risks to even well-informed borrowers is difficult; to a borrower without financial literacy, it is nearly impossible.

*Asymmetric Information and Adverse Selection: Originators and Investors*

The subprime crisis has revealed a number of puzzling aspects about investor behavior with respect to (1) the relationship between investors in securities and loan originators, (2) the nature of diversification, and (3) investor understanding about housing market risk.

The behavior of investors with respect to subprime mortgages is puzzling, to say the least. Mortgage originators had powerful incentives to originate loans, regardless of quality: every mortgage that was successfully originated and sold to an investor produced a fee for the originator. While companies that originated the loan, such as New Century, could give representations and warranties to investors that loans met some minimum standard, they were not well enough capitalized to make good on any promises in the event of large-scale default. It is difficult to understand why this was not clear to investors *ex ante*.

The second puzzle is that investors and rating agencies appeared to believe that diversification *per se* could cause systematic risk to disappear. It is of course the case that as a security becomes more diversified, unsystematic risk will get smaller, but mortgages with ten percent default probabilities will continue to carry such probabilities, regardless of the securities in which they are packaged (Coval et al. 2007).

The third puzzle is investors' seeming lack of understanding about housing market risk. Commentary in the popular press could be schizophrenic about potential risk in the housing market. On the one hand, stories about a potential housing bubble in the

United States date back to at least 2002.<sup>30</sup> On the other hand, Fannie Mae and Freddie Mac came under severe criticism for having high current returns on equity on their guarantee business. The Fannie and Freddie guarantee business collects fees from holders of Mortgage Backed Securities in exchange for guaranteeing timely payment of principal and interest. Implicit in the criticism of Fannie and Freddie was a charge that the fees they collected were “too high” in light of how rare default and foreclosure were.

Indeed, Fannie and Freddie had credit losses of a basis point or less in every year between 1999 and 2004.<sup>31</sup> The reason for this is that house prices rose smartly and ubiquitously over this period of time. In past periods, however, when house prices fell in various regions of the country—in the upper-Midwest in the 1970s, in the old-patch in the 1980s, and on the Coasts in the 1990s—default costs were considerably higher. Some FHA cohorts from the 1980s had a default rate of more than 19 percent (Capone 2000). It is not clear what history of house prices investors were relying on when they decided they decided the yields they received were acceptable in exchange for the risks they were taking on.

The Wall Street Journal recently reported (August 15, 2007) that rating agencies chose not to change the ratings of MBS that were more liberally underwritten, until they actually began to fail. Moreover when investors mis-price risk the result is the artificial inflation of housing prices. The pricing boom of 2006 was likely in part due to this unsustainable credit boom Pavlov and Wachter (2007a).

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<sup>30</sup> See, for example, Erin Schulte, Housing Strength Raises Another Bubble Concern, *Wall Street Journal*, March 29, 2002.

<sup>31</sup> See OFHEO (2006).

A theme across all these puzzles is the lack of transparency, which in turn led agents to make uninformed decisions.

## **Conclusion**

We take away three lessons from our observations of the housing finance revolution. First, mortgage markets that are linked to capital markets are better for consumers and investors, than mortgage systems where the price and allocation of mortgages is determined by government.

Second, there are countries that do not have access to long-term capital and therefore do not have fully functioning mortgage markets, and the development of such markets would allow borrower access to mortgages with long terms. Nonetheless, among the alternate vehicles of depositories, covered bonds, and securitization, it is not at all clear whether there is a “best” channel for attaching mortgages to capital markets. To some extent, the policy issue with respect to channels is where risk is best managed. Depositories manage interest rate risk by having such assets as adjustable rate mortgages. But if households only have adjustable-rate mortgages available to them, they must balance their long-duration asset—their house—against a short-duration liability. This can expose homeowners to mortgage payment shocks and thereby induce macroeconomic instability.

On the other hand, the US mortgage backed security structure gives borrowers access to fixed rates over long terms as well as the option of prepayment. This means holders of mortgage backed securities are exposed to interest rate risk regardless of how rates move: they take capital losses when rates rise, and they must reinvestment in

securities with lower interest rates at par when rates fall. While investors in agency MBS take on substantial interest rate risk, they do not take on much credit risk, which is instead born by the GSE intermediaries—Fannie Mae and Freddie Mac. The relatively low spreads on Fannie Mae and Freddie Mac securities imply that investors either have a great deal of confidence in their ability to manage credit risk, or confidence in the amorphous relationship between the GSEs and the Federal Government. We have some suspicion that it is the relationship between the Government and the GSEs that has allowed Fannie Mae and Freddie Mac to develop uniform underwriting instruments, which in turn has produced homogenous mortgages that can easily be bundled into liquid securities.

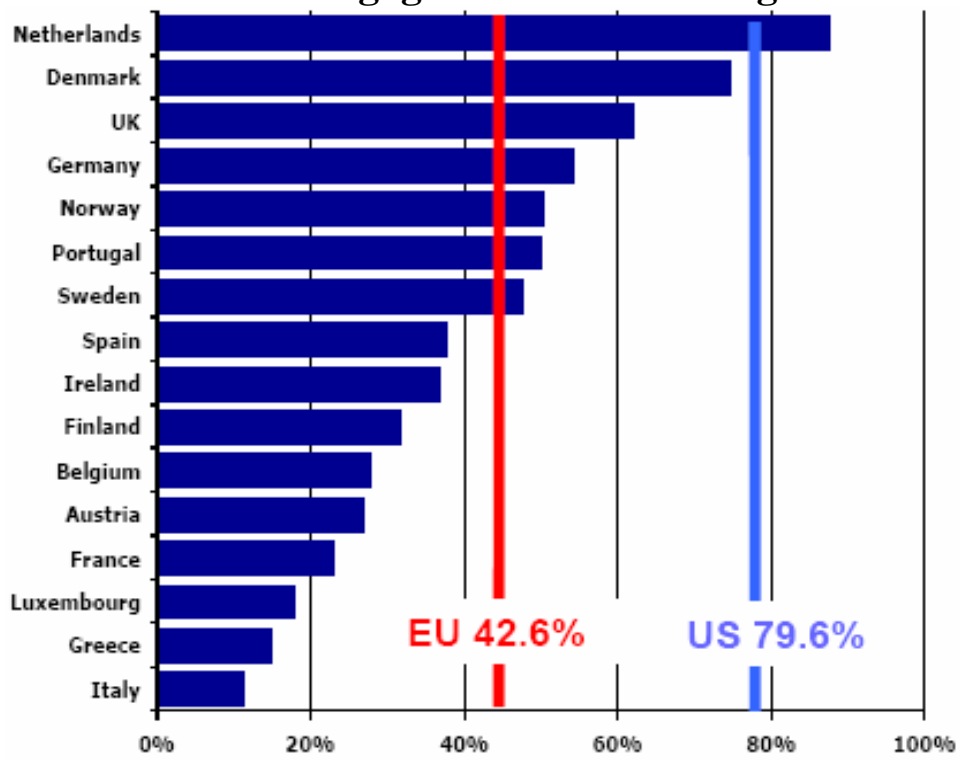
Finally, the German covered bond system divides risk between investors and borrowers differently. Mortgages in Germany have long terms, but carry less market rate risk relative to American MBS for investors, because borrowers are effectively prevented from prepaying their mortgages. . German mortgages that are funded with covered bonds are also heavily over-collateralized, and consequently carry little credit risk. Borrowers, on the other hand, are faced with large prepayment penalties should they wish to refinance or even sell their house, but have the benefit of knowing that their payments are fixed for a long period.

The current US crisis is centered in the private label securitization market and is driven by the uncertainty of credit outcomes in subprime and jumbo MBS. As a result of the crisis, bank originators of these loans may need to provide additional on balance sheet funding. If banks fund these mortgages on balance sheet they will be faced with

additional interest rate risk (unless either only short term maturities are offered or prepayment is sharply curtailed), and as well as credit risk.

Third, underwriting is necessary. No amount of sophisticated structured finance can overcome the lack of sound underwriting. The absence of underwriting means investors face uncertainty, rather than risk, making informed investor choice impossible.

## Exhibit 1 Residential Mortgage Debt Outstanding to GDP



Sources: European Mortgage Federation, Federal Reserve System, Dubel

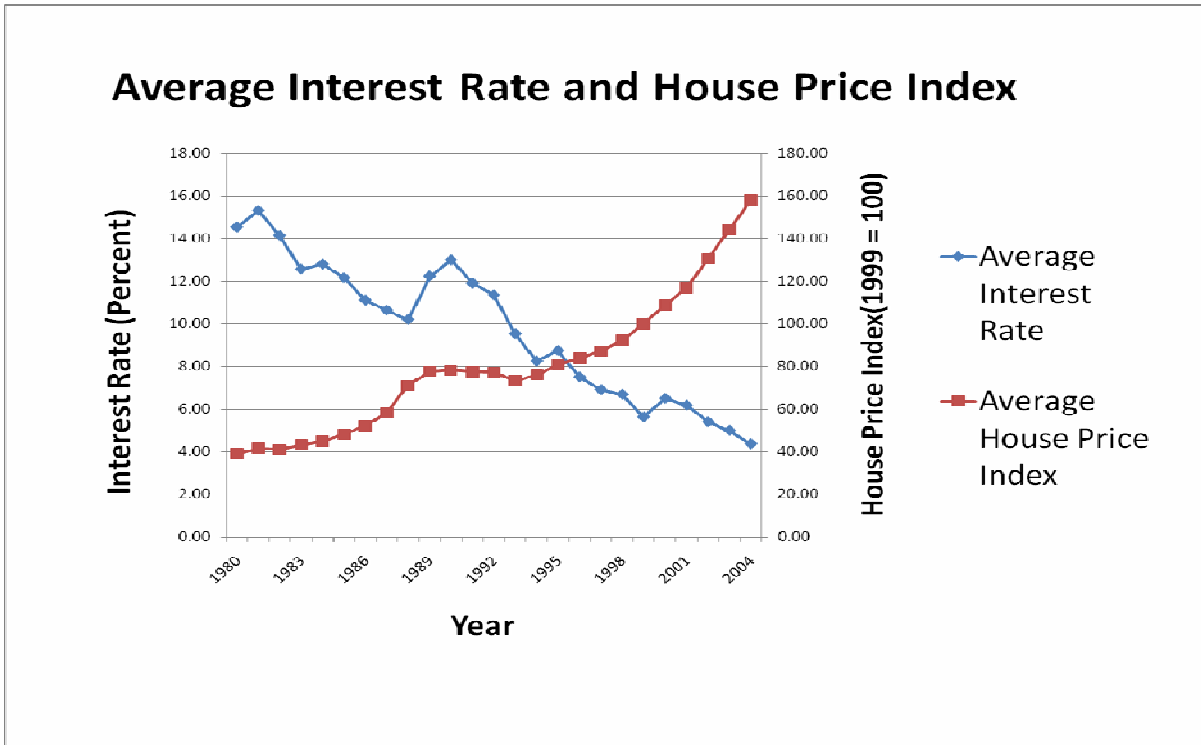
## Exhibit 2

### Selected Mortgage Market Growth Rates Per Annum

<b>European Union</b> 8.2 % <i>average of 15 countries</i> (1992/2002)	
Greece	23.5%
Portugal	22.5%
Ireland	18%
Spain	17%
Germany	6%
France	4%
Finland	3.5%
Sweden	2.5%
<b>United States</b> 8% (1993/2002)	

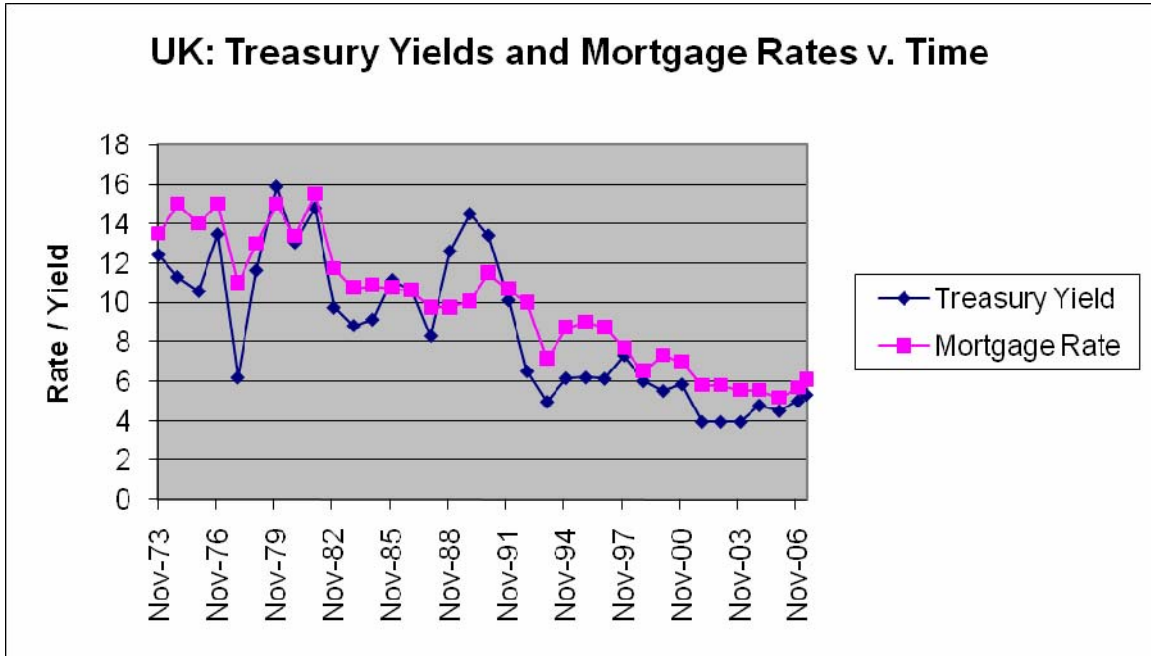
*Source: European Mortgage Federation, Federal Reserve System, Dubel*

**Exhibit 3**  
**Global Average Interest Rate and House Price Index**



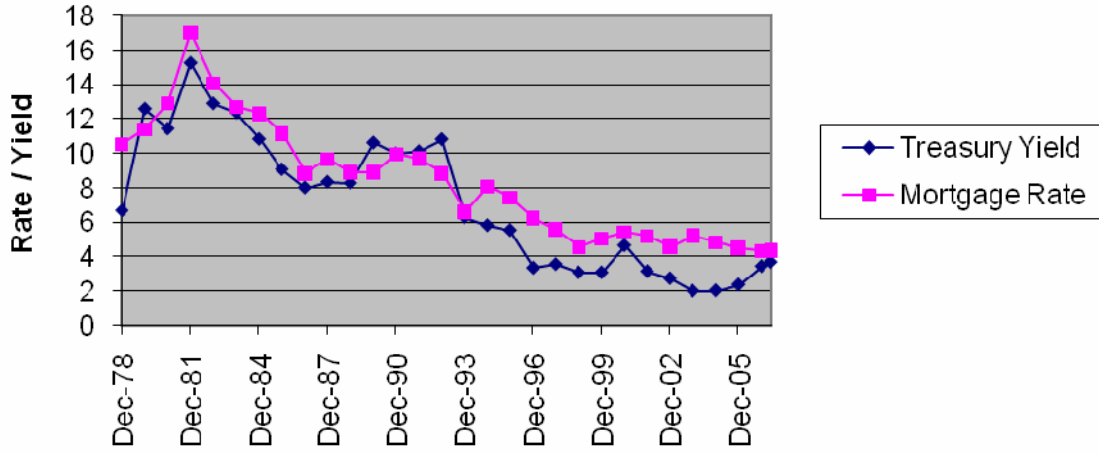
*Source: Bank of International Settlements House Price Index  
 Interest Data from U.N. Statistical Database*

*Exhibit 4*  
*Treasury Yields and Mortgage Rates*  
*United Kingdom*



*Exhibit 5*  
*Treasury Yields and Mortgage Rates*  
*France*

**France: Treasury Yields and Mortgage Rates v. Time**



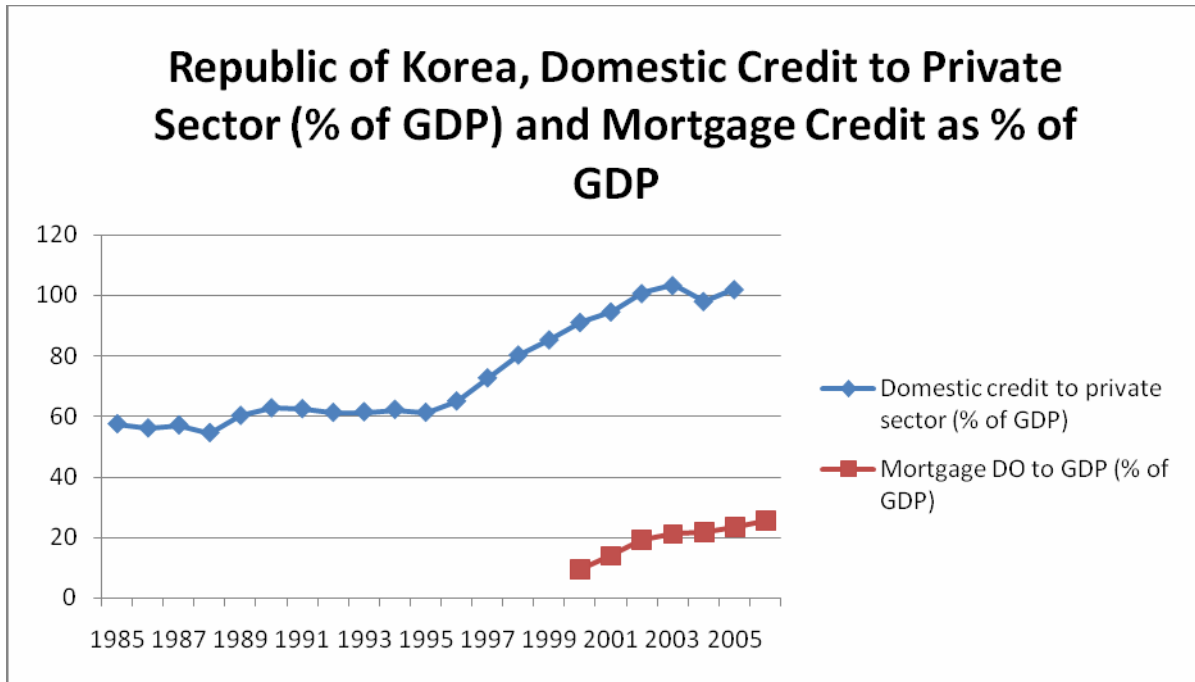
*Exhibit 6*

*Interest Rate Coefficient on Simple Granger Causality Regressions*

<b>Country</b>	<b>Interest rate coefficient, C(3)</b>	<b>St. Error</b>	<b>t-statistic</b>
Pooled (1980-2004)	-0.46	0.12	-3.87
Australia(1986-2004)	-0.40	0.49	-0.81
Belgium(1991-2004)	-0.02	0.28	-0.07
Canada(1980-2004)	-0.42	0.29	-1.48
Sweden(1981-2004)	-0.53	0.21	-2.49
United Kingdom(1980-2004)	-1.08	0.48	-2.25
United States(1980-2004)	-0.19	0.14	-1.35

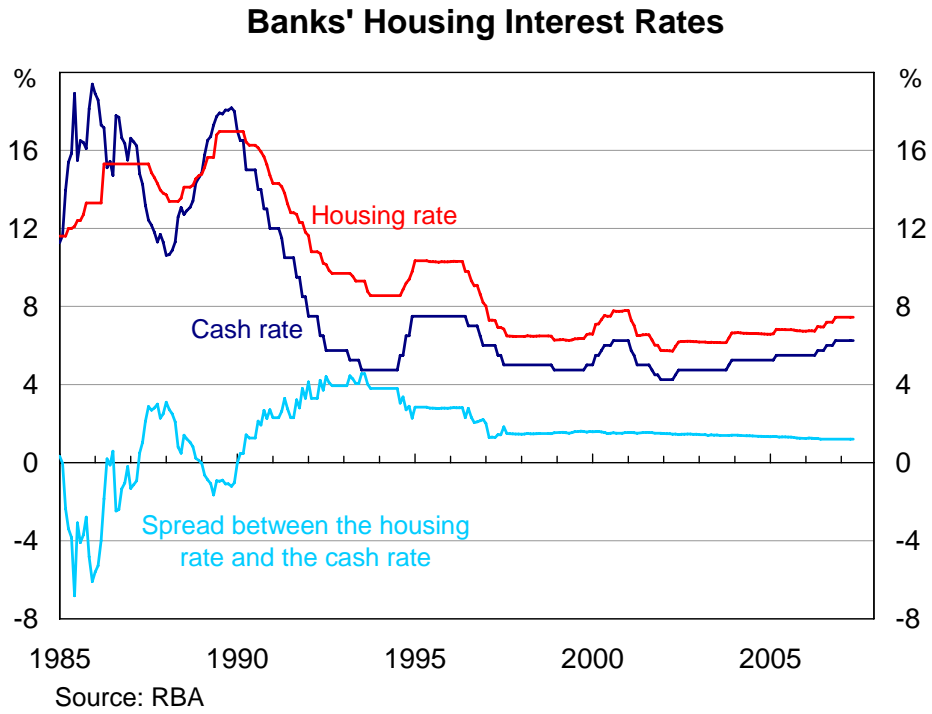
*Source: BIS Price Data. Regression is  $P - P(-1) = C(1) + C(2)*(P(-1) - P(-2)) + C(3)*I(-1)$ , where  $P$  is house price level and  $I$  is nominal interest rate.*

*Exhibit 7*  
*Growth of Mortgage and Consumer Credit in Korea*



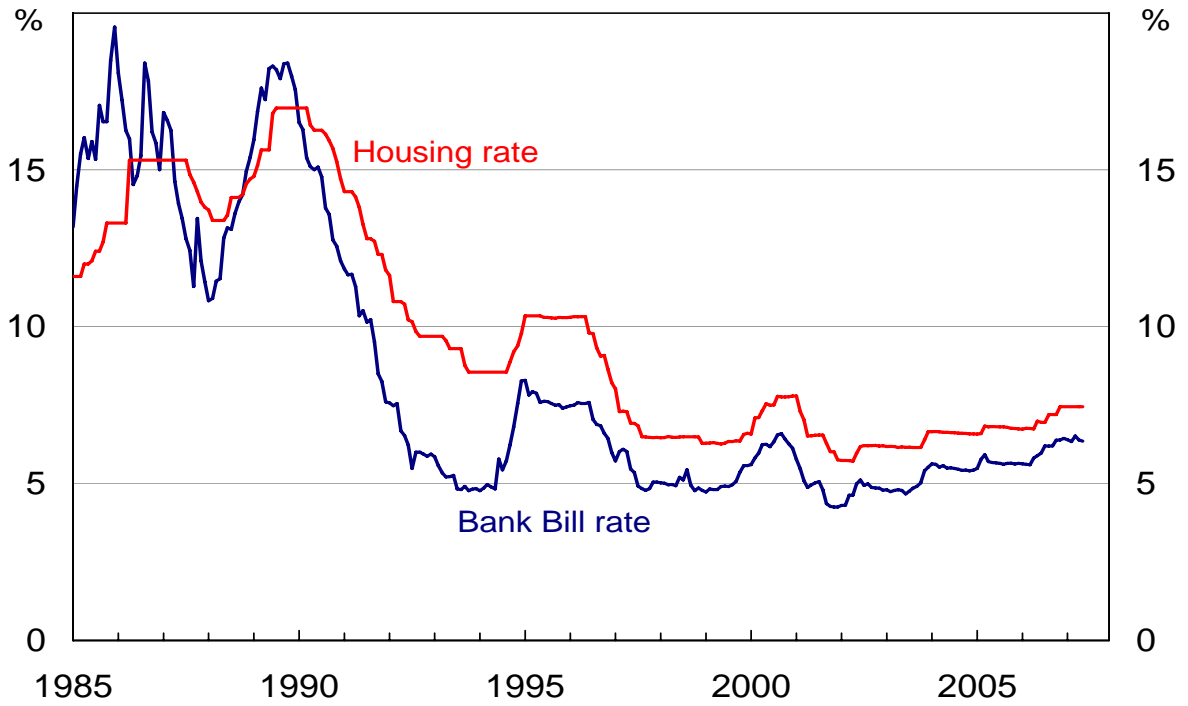
*Source: Bank of Korea*

*Exhibit 8*  
*Australia Banks' Housing Interest Rates*



*Exhibit 9*  
*Bill Rate and Housing Rates in Australia*

**Bank Bill Rate and Housing Interest Rates**

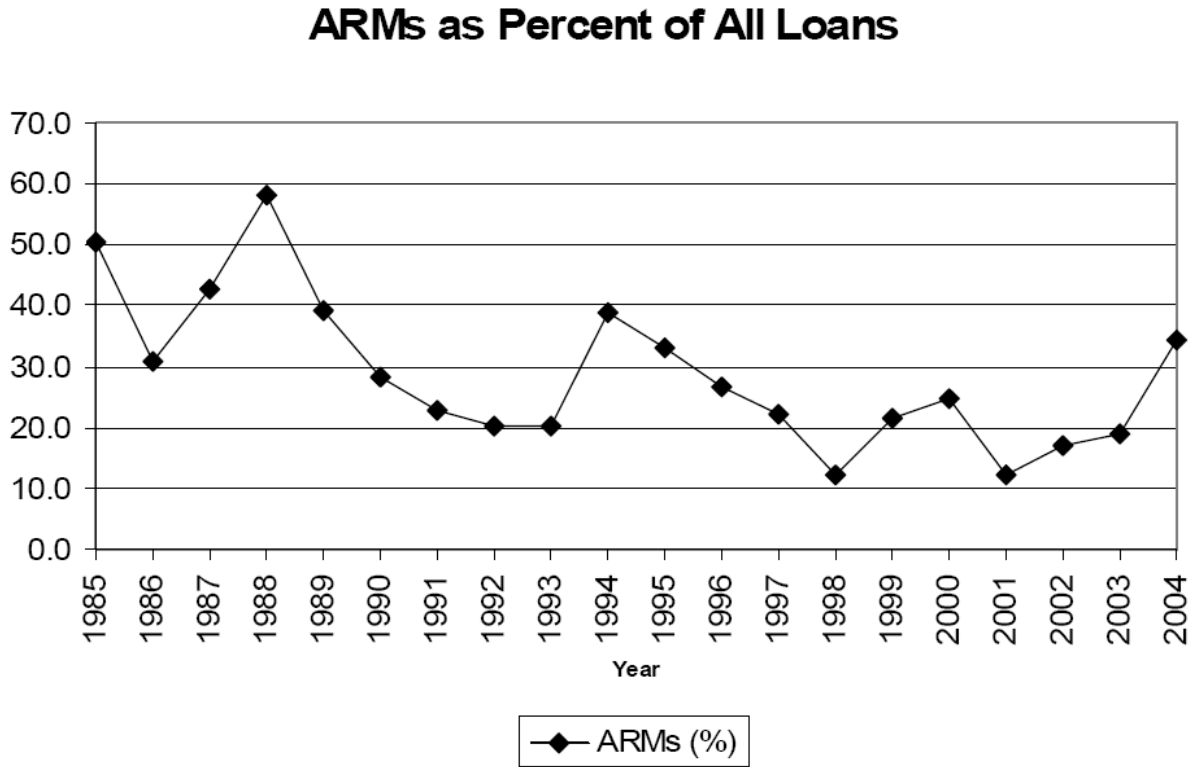


Source: RBA

*Exhibit 10*  
*Mortgage Debt as a % of GDP in the United States*

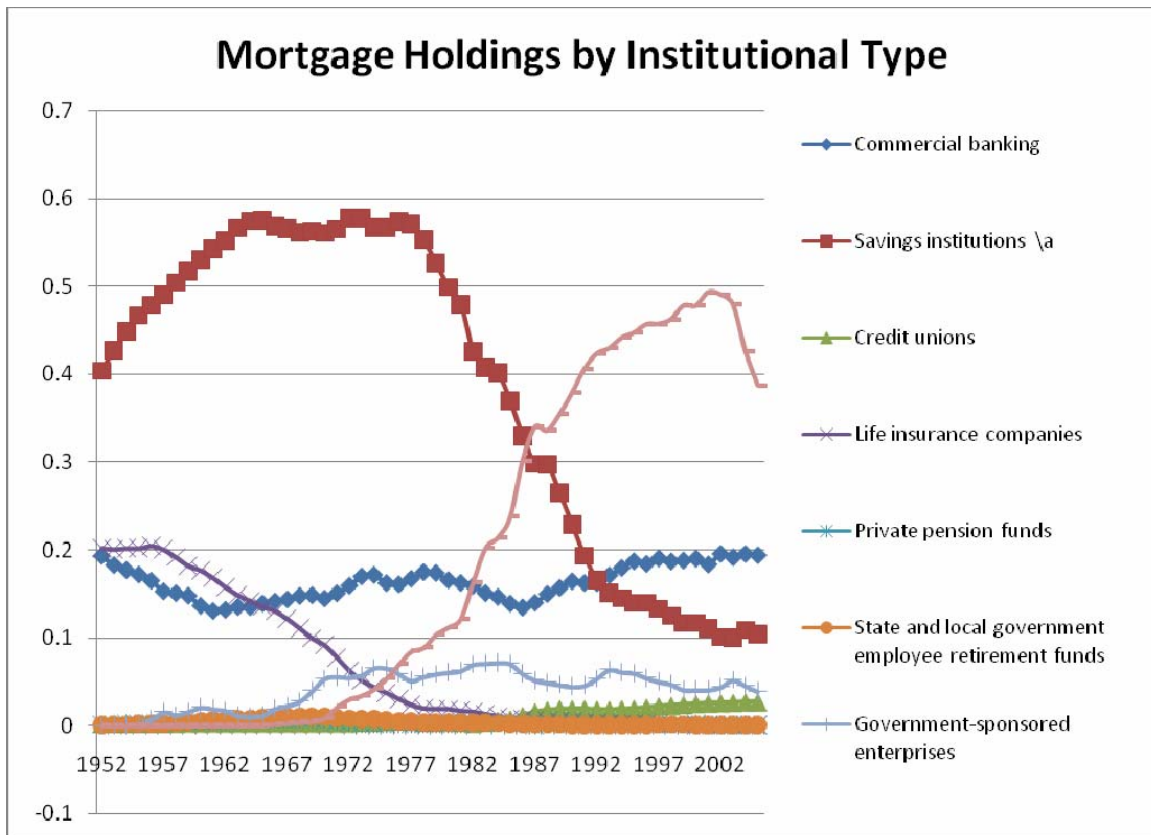


*Exhibit 11*  
*ARMs in the United States as A Percentage of All Loans*

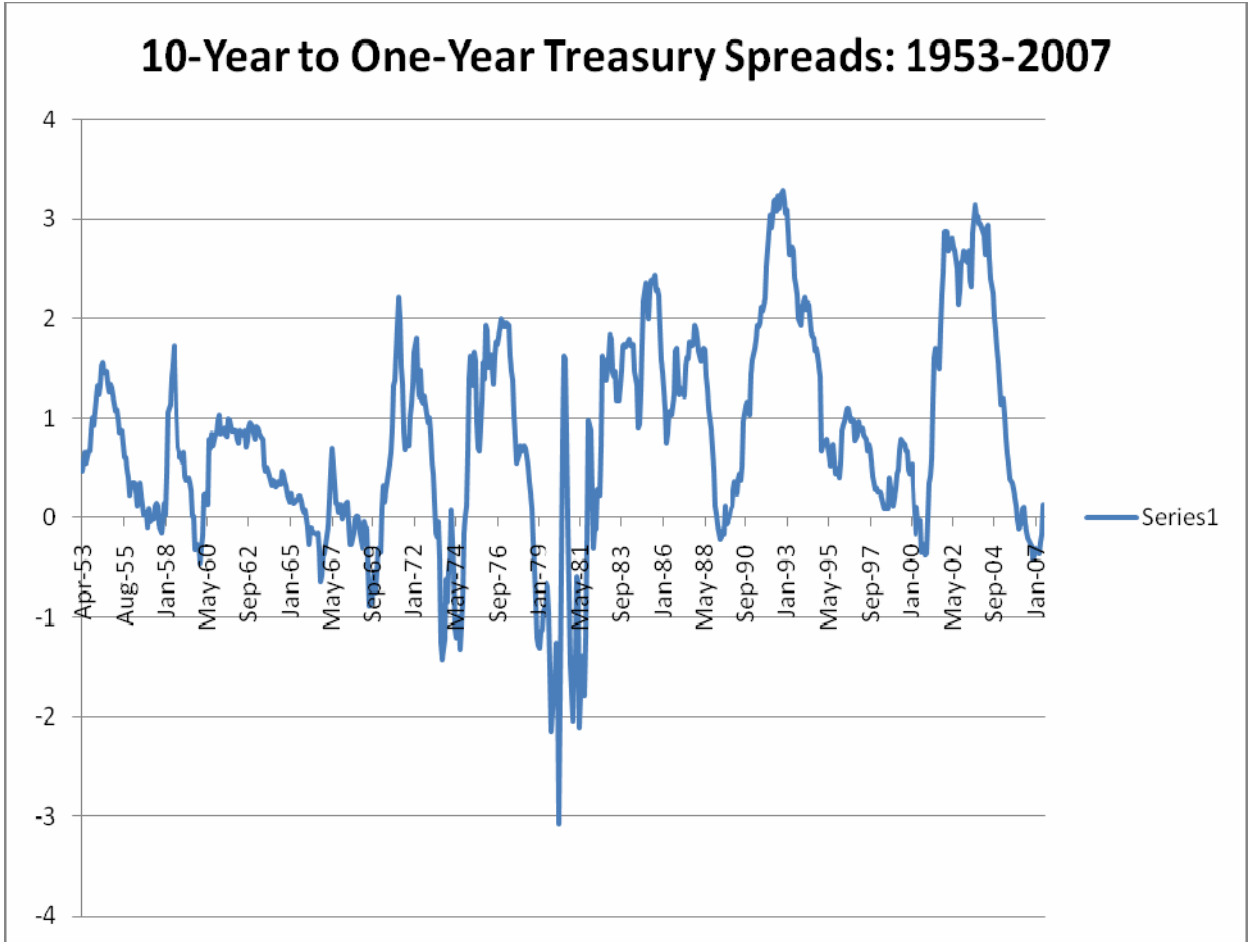


*Source: Federal Housing Finance Board*

**Exhibit 12**  
**Mortgage Holdings by Institutional Type in the United States**



*Exhibit 13*  
*Yield Curve, Treasury Spreads, United States*



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