

General Discussion: The Housing Finance Revolution

Chair: Otmar Issing

Mr. Issing: I think the authors have demonstrated that we can understand the present system and its problems only by looking into the past and into the evolution of the system as we have it today. Because of time constraints, I would like to draw your attention to probably two questions. First, we have seen that markets have become more efficient. But, as Bill White has indicated at the end of his contribution, the question is, Did this come at a price, and what was the price?

Second, indeed we have seen convergence of systems across the world. The authors have even referred to countries like Bangladesh, but we still have differences. At the same time, countries that have different systems at home are connected by investors' decisions globally. So, you might have a country like Germany, which has a relatively conservative mortgage system, but, at the same time, German banks and institutions have bought collateralized debt obligations that come from other markets.

You have this combination of, on the one hand, globalization of investors' decision and, on the other hand, institutional differences. Perhaps these are two issues to draw your attention to.

Mr. Meltzer: I thought Bill White brought up what is a really crucial point that isn't much discussed—that is, there is a sharp policy implication, it seems to me, in all of these papers. It has to do with the fact, as he said, that the risk has been taken out of the banking system, which is in many ways a good thing, but it has been placed who knows where. You find out only when there are failures and defaults, for the most part.

So, with this change, there is a change in responsibility if we rely on failures to discipline the lenders and the financiers because central banks don't know where the risks are and are not in a good position to overcome them. We can't expect either central banks or regulation to do some of the things they did wisely or foolishly in the past.

What is needed now is for the central banks to announce that is their policy—that is, to tell people that if you are going to take these risks and you want help, you had better be holding collateral that we find acceptable. Otherwise, you are at risk of default.

In the 90-year history, the Fed has never announced a strategy, and it has never followed a consistent path. Sometimes it does bailouts. Sometimes it doesn't. That creates, and I think it is quite obvious at the moment, unnecessary uncertainty while the market waits to see which way the Fed will jump and whether they and Congress and others can force them to make that jump. It is commendable that so far they haven't done that, but they would be better off and policy would be better off if we knew that was strategy and only people who hold collateral can expect to be saved. That is a task which I think central banks have been reluctant, certainly here, to undertake, but at the present way in which risks are divided, it becomes extremely important.

It becomes extremely important in the European Central Bank (ECB) also because, in the ECB, there really isn't an effective lender of last resort in the same sense that can create liquidity or is responsible for creating liquidity in the various countries to even out the risks.

So, that is a challenge to the central bankers. It seems to me that Bill White's comment really gets to the policy implication of recent action.

Mr. Visco: I would like to consider some effects of securitization on housing market loans. We have been presented with the effects on lenders, the incentives to them to originate loans with little attention to their quality, an aspect that has been most emphasized by Susan Wachter, Richard Green, and Bill. The reason is they could be easily sold to investors.

Now, what about the borrowers? In the past, as it is still the case in many countries, there were personal relations between lenders and borrowers that allowed the borrowers who were temporarily in difficult financial conditions to get some flexibility, some margins, and somehow come with payments with some lags and solve their situation.

Now, what we have is that, if these loans are actually in the hands of foreign banks or international hedge funds, it might be almost automatic to have foreclosures generated by attempts to contain losses once the falls in housing prices start being observed. This could lead to a vicious circle, with further falls in prices and defaults.

The question is, In a securitized world, which has many advantages as we know, would it be possible to write contracts in a way that would restore some flexibility, some margins to the borrowers?

Ms. Wachter: It is a difficult question.

Mr. Green: One thing that is encouraging is Fannie Mae and Freddie Mac have developed automated servicing models, where they look at borrowers who are 30 days delinquent and try to figure out what kind of borrower they are. Is the 30-day likely to turn into a 60-day? And then they try to react accordingly. So, there is an attempt to use automation in order to figure out the cost-minimizing way to cure the problem, but that is within a fairly narrow part of the overall securitization market. That is the good news story.

The bad news story is these securities get sliced up into tranches. Very often it is the case that, within different tranches, investors have different incentives with respect to how delinquent loans are treated. Some may want to renegotiate and others might not. So, you have an apparent conflict within the securities themselves about how to deal with the borrowers. That can make the flexibility difficult.

Mr. White: Just to respond to Allan Meltzer's comment. A phrase one hears increasingly in central banking circles these days is "constructive clarity," as opposed to constructive ambiguity. So, there is a tendency for people to react to these kinds of concerns.

The second point I would make refers to Ignazio Visco's comment about workouts. It does seem to me that in the kind of world that we have, which is effectively much more dependent on market securitization and in a global context, it makes workouts of all sorts much more difficult. The days when you could get Bill McDonough or Bill Rhodes and 10 people around a table and sort it out, those days are basically gone.

One of the worrisome aspects of this is that it does mean—because of the difficulties of doing traditional workouts—that there is more of a reliance to go back to monetary policy as really the only tool that remains to help sort out difficulties. If one could find institutional ways of ensuring an easier workout process, whether in the housing area or elsewhere, it would be extremely helpful.