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TWO APPROACHES TO GSE REFORM

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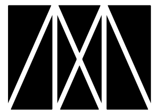

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Arnold Kling

INTRODUCTION AND SUMMARY

In this paper, I offer two alternatives to reforming Freddie Mac and Fannie Mae, the government-sponsored enterprises (GSEs). One approach is to restore the *status quo ante*, meaning that Freddie Mac and Fannie Mae would be returned to the investing public as private corporations with government backing, able to purchase loans for securities and able to hold securities in portfolio, subject to limits on loan amounts and subject to safety-and-soundness regulation. I call this the “devil you know” strategy, because I believe it would be safer than trying to create a new form of government-guaranteed mortgage system. The other approach would be for the government to get out of the mortgage-guarantee business, and to let the mortgage market evolve in a decentralized way, I call this the “Jimmy Stewart banker” strategy, because my expectation is that it would return mortgage lending to local banks, which would retain the loans that they originate.

The “devil you know” approach of reviving the GSE model has a number of advantages. It would ensure the survival of the 30-year fixed-rate mortgage. It would take advantage of the substantial organizational capital that the GSEs have accumulated with respect to standardizing mortgage lending, managing credit and interest-rate risk, and using computer technology to handle complexity and achieve reliability. In addition, there is a regulatory model for the GSEs, based on stress testing, that is very robust: it only failed because political leaders imposed other priorities on the GSEs that were in conflict with safety and soundness. With the lessons learned so painfully in the recent crisis, this regulatory model can be solidified.

Any attempt to reengineer a housing-finance system with a new set of government-guaranteed entities would entail all of the risks of restoring the existing GSEs, plus more. The taxpayers would be exposed to similar potential hazards, but with new and inexperienced organizations engaged at the level of enterprise management and regulatory oversight.

The “Jimmy Stewart banker” approach has the advantage of reducing the involvement of the federal government in the mortgage market. It likely would lead to a more decentralized mortgage-finance system, with a much smaller role for Wall Street, thus reviving an American tradition of smaller, independent financial institutions. It would create a playing field that is not dominated by gigantic, government-advantaged firms. It would offer politicians less opportunity to impose priorities on the mortgage-lending process that produce instability and hazard. It would not set up a game in which GSE shareholders have an interest in seeking out high-risk, high-return strategies that conflict with the public interest.

In the next section of this paper, I discuss public policy objectives that pertain to housing and the GSEs. Then, I describe the “devil you know” approach of restoring the GSEs with an improved regulatory structure. After that, I describe the “Jimmy Stewart banker” approach, in which mortgage lending might revert to an originate-and-hold model, rather than rely on securitization. In the conclusion, I explain why this latter approach may be preferable.

PUBLIC POLICY OBJECTIVES

In my opinion, the key to successful reform in housing finance is clarifying the public policy objectives. Vague and contradictory objectives played a large role in the catastrophe that befell Freddie Mac and Fannie Mae. In particular, the phrase “affordable housing” is gauzy and imprecise, and this creates a dysfunctional tension between public and private objectives.

Former Treasury Secretary Lawrence Summers expressed the frustration of dealing with this lack of clarity:

> What went wrong? The illusion that the companies were doing virtuous work made it impossible to build a political case for serious regulation. When there were social failures the companies always blamed their need to perform for the shareholders. When there were business failures it was always the result of their social obligations. Government budget discipline was not appropriate because it was always emphasized that they were

"private companies." But market discipline was nearly nonexistent given the general perception—now validated—that their debt was government backed. Little wonder with gains privatized and losses socialized that the enterprises have gambled their way into financial catastrophe.[1]

The lack of clear public policy objectives created an opening for the executives of Fannie Mae and Freddie Mac were able to steamroller those from the private sector or in Washington who might attempt to get in the way.[2]

Rather than employing the vague term "affordable housing," policy makers should articulate clear objectives with respect to the mortgage market. The issues include the extent to which government should subsidize mortgage credit, goals for the distribution of mortgage credit, and goals for shaping the types of loans available in the market.

Policy makers have wanted to encourage home ownership. There is a belief that owners create stable communities where properties are well maintained. There is a concern that renting is associated with transience and property depreciation. In addition, home ownership can promote thrift. As mortgage loans amortize and as house prices increase, home owners accumulate an asset in the form of home equity. (Note that with a fixed-rate, level-payment mortgage, equity accumulates as long as house prices rise, even if they rise more slowly than the overall rate of inflation.)

In practice, pursuit of these goals through mortgage policy has been inefficient and even counterproductive. Subsidized mortgage credit helps to drive up home prices, so that the effect on the home ownership is attenuated, as higher prices put homes out of reach for the marginal household. In recent years , the frenzy of mortgage lending fueled speculative purchases, with 15 percent of mortgage loans going for owners who were not occupants of the houses that they were financing.[3] Moreover, the goal of encouraging thrift and the accumulation of assets was undermined by the proliferation of lending with loan down payments, exotic mortgage instruments in which principal is not reduced over time, cash-out refinancing, and second mortgages.

The issue of the distribution of mortgage credit caused much confusion. The GSEs were given quotas with respect to the income of borrowers, and those quotas were used in part to justify a foray into risky lending activities. As the housing bubble inflated, the quotas were raised, forcing the GSEs to acquire more mortgages from low-income borrowers even as the ratio of median house price to median income was rising.

Another reason that the GSEs undertook risky activities is that they were "following the market." If they are going to serve a public policy purpose of shaping the types of mortgage loans, then they should be holding fast to principles of responsible lending, rather than following fashions.

Overall, the involvement of the GSEs in mortgage finance was totally out of proportion relative to the limited public policy objectives that are reasonable. They were financial behemoths and political giants, but the social goals for housing

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1 Lawrence Summers, "You Want Creative Capitalism? Try This," in Michael Kinsley, ed., *Creative Capitalism: A Conversation with Bill Gates, Warren Buffett, and Other Economic Leaders* . N.Y., NY: Simon and Schuster, 2008. p. 196.

2 See the anecdotes in Bethany McLean and Joe Nocera, *All The Devils are Here*. N.Y., NY: Portfolio/Penguiin, 2010. For example, on p. 17,

How did Fannie Mae persuade Pierce to rule in its favor? Not be sweet-talking, that's for sure; Maxwell had an iron fist inside that velvet glove of his. "We essentially gutted some of HUD's control over us in a bill that passed the House housing subcommittee," Maloni says today. In that bill, HUD's ability to approve new programs was revoked. HUD went to Fannie, and essentially pleaded for mercy. "In return for asking the Congress to drop the provision, HUD approved Fannie as issuers," says Maloni.

Maloni also called Lou Nevins and told him that if Salomon didn't back off, Fannie wouldn't do business with the bank anymore... This was a major threat. "It's like the post office saying we won't deliver your mail!" Nevins says. He remembers thinking to himself, "If they get away with this, there won't be a private company in the world that will stand up to them."

3 See Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "The 2006 HMDA Data," *Federal Reserve Bulletin*, December 2007, pp. A73-A109.

policy were poorly addressed and the ultimate risks borne by taxpayers cannot be justified.

Going forward, I would recommend clarifying objectives in the following ways:

Public policy should not seek to encourage mortgage borrowing as a means for promoting home ownership. Instead, home ownership should be presumed to embody a significant down payment (10 percent or more) and the gradual accumulation of equity. We should not encourage the dissipation of home equity through non-amortizing mortgage loans, cash-out refinancing, or second mortgages.

Public policy should not encourage lenient mortgage credit as a means for engaging in redistribution. Assistance for low-income households should consist of grants that are explicitly accounted for in the government budget.

To the extent that the government intervenes in the mortgage market, it should be selective in the products it supports, rather than subsidizing any and all forms of mortgage lending. In particular, we should consider limiting the subsidy to first mortgage loans for purchase of an owner-occupied home, with amortization that accumulates equity and a rate of interest that is fixed for five years or longer. The market may offer loans for refinancing, second mortgages, loans for non-owner-occupied homes, non-amortizing loans, and short-term adjustable-rate loans, but there is no reason for government-backed agencies to become involved in those activities.

If policy makers agree that government involvement in the mortgage market should be limited to the purpose of supporting the mortgage products that encourage the prudent accumulation of equity in homes, then it should be feasible to develop a mortgage finance strategy that is sound. On the other hand, if the government's objectives for the mortgage market remain broad and poorly specified, then any approach to reforming housing finance is likely to fail.

THE DEVIL YOU KNOW

Before we bury Freddie Mac and Fannie Mae, we should praise them. As tools for making capital available for mortgage lending, the GSEs are efficient. Mortgage rates in the market for loans eligible for sale to the GSEs were typically 0.25 to 0.50 percentage points below those on comparable loans in the “jumbo” market (for mortgage above the limit set for the GSEs by Congress). Although some of this difference may have been due to the perception of a government guarantee, it should be noted that banks and thrifts that can serve the “jumbo” market also have access to a government guarantee in the form of deposit insurance.

The GSEs’ risk-management strategies and systems are very sophisticated, well-developed, and sound. These systems failed largely due to the pressure applied by political leaders to provide lenient, subsidized mortgage credit to fuel an unsustainable expansion of speculative home buying.

In order to be able to channel capital from around the world into loans to individual American households to buy homes, the GSEs had to create standards for mortgage underwriting and processing. This standardization is a success story.

Mortgage underwriting is subject to the classic statistical problem of type I and type II error. Type I error is the approval of a mortgage for a borrower who subsequently defaults. This error imposes a large cost on the borrower and the lender. Type II error is the failure to approve a mortgage for a borrower who would have repaid the loan as scheduled. Committing this error causes both the lender and the borrower to miss out on the opportunity for a mutually beneficial transaction.

Political leaders often seem unable to grasp these elementary concepts. Before the financial crisis, politicians complained about mortgage borrowers who were being turned down for loans. Implicitly, the politicians were unwilling to forgive type II errors. On the other hand, after the crisis, legislative language was proposed to forbid mortgage lenders from making loans to borrowers who could not repay, in effect trying to outlaw type I errors.

This political criticism is unwarranted and only served to exacerbate the housing cycle. During a boom, type I errors are forgiven by rising house prices that insulate lenders from risk, so that it is easy for politicians to complain that too many mortgage applicants are being turned down. On the other hand, in the wake of a crash, threatening to criminalize type I errors will take away lenders' willingness to absorb risk at the time when the market needs it most.

In fact, it is unrealistic to expect to eliminate either type of error completely. The practice of underwriting is an effort to try to cut down on both types of errors as much as possible.

Over the last several decades, the GSEs have continually improved the accuracy of underwriting decision-making, making it possible to commit fewer type II errors without adding to the risk of type I error. In addition, their promulgation of standards and automation technology has lowered the administrative costs involved in mortgage underwriting.

In addition to underwriting standards, GSEs have developed a number of risk management tools for addressing the moral hazard that is associated with the process of originating mortgage loans for sale to third parties. They implement quality-control audits of lenders who sell loans, and they require lenders to buy back loans that do not fall within underwriting perimeters or lack proper documentation. They set minimum capital standards for sellers in order to ensure that originators can in fact stand behind the loans that they sell. They issue guidelines and training manuals to foster compliance with standards.

The GSEs use risk-based pricing, loss reserving, and capital policies. This means that for loans with lower down payments or other characteristics that add to risk, higher interest rates are charged, more reserves are set aside to cover potential losses, and a larger capital base is maintained.

The capital base is calibrated to withstand a severe stress test. At one time, the stress test was patterned after the experience of collapsing home values during the Great Depression. Subsequently, the stress test was moderated to be patterned after large regional downturns in the post-war period.

Over the past decade, many critics of the GSEs warned that their large size and high leverage posed a risk to taxpayers. However, these critics tended to see interest-rate risk as the primary threat. Rather than sell mortgage securities to other institutions, the GSEs increasingly held securities in their own portfolios, financed by debt. This creates a risk of maturity mismatch. If the average duration of mortgage security assets in your portfolio is 20 years, and the average duration of your debt is 5 years, then rising interest rates can cause a significant loss in market value. Given the high ratio of assets to capital at these enterprises, the result could be catastrophic losses. This sort of loss plagued the savings-and-loan industry in the 1970s and early 1980s, and in fact Fannie Mae in that period suffered losses and may even have been technically bankrupt. (Freddie Mac in that period held a negligible portfolio.)

As it turns out, interest-rate risk was not a factor in the collapse of the GSEs. (They had to be bailed out because of credit losses.) In fact, they have developed effective mechanisms for adjusting their portfolios to remain hedged with respect to the level and volatility of interest rates. Their interest-rate positions also are subjected to severe stress tests (variation up or down in interest rates) in order to determine capital standards. This approach to managing interest-rate risk is as sound as one could hope for.

With all of these mechanisms in place, why did the GSEs absorb large losses, so that they had to be taken into conservatorship in 2008? Narrowly speaking, there appear to be two reasons. One reason is that their capital was overstated, because they counted as capital items, such as tax-loss carry-forwards, which did not constitute part of an asset base that could be absorb losses, which is the purpose of capital. Another reason is that as the GSEs strayed far from the investment-quality lending (meaning mortgages with significant down payments and other risk-reducing characteristics) that was their original charter, they failed to assess the impact of these higher-risk loans on capital needs under a stress scenario.

The agency that regulated the GSEs, known at the time as the Office of Federal Housing Enterprise Oversight (OFHEO), was derelict in executing its authority. Critics have correctly pointed out that OFHEO was structured as an arm of the Department of Housing and Urban Development (HUD), rather than the Department of the Treasury. HUD's primary mission is to promote better housing and expanded home ownership, and it was pressing the GSEs to meet affordable housing goals, which conflicted with the objective of maintaining safety and soundness.

In view of this past experience, the "devil you know" approach should consist of the following elements.

The plan should be to return the GSEs to shareholder-owned status. This probably requires wiping out existing

shareholders, creating a “bad bank” to hold the securities backed by low-quality mortgages, and capitalizing the two enterprises with new initial public offerings.

Responsibility for regulatory oversight of the GSEs should be placed under the Department of the Treasury, with a mandate to focus solely on safety and soundness. The stress-test approach should be constantly improved. Above all, capital standards should be enforced, and only capital that can absorb losses should be counted.

The practice of assigning affordable housing goals to the GSEs should be abandoned. Instead of creating incentives for the GSEs to undertake risky lending, the mandate to purchase only investment-quality loans should be reiterated and strengthened.

The core mission of the GSEs should be to provide long-term, fixed-rate mortgage loans to clearly qualified borrowers, who make sizable down payments. A down payment of 20 percent (or 10 percent if supplemented with private mortgage insurance) was once standard, and ought to become standard again. More exotic mortgage instruments might be provided by fully private lenders, but the GSEs do not need to support that market. Public policy goals to expand home ownership should be pursued using explicit, on-budget subsidies, not through cross-subsidization mandated by quotas imposed on the GSEs.

The GSEs should continue to be able to hold portfolios and to manage interest-rate risk, subject to capital and regulatory requirements. However, Treasury should prevent and penalize any attempts by the GSEs to exploit their low borrowing costs by engaging in hedge-fund-like activities or other financial strategies that are not essential to the mortgage securities business.

To avoid a repeat of the current foreclosure mess and to ensure clear property records moving forward, an agency should be created to replace local property recording offices with a definitive, standardized national database. This is probably a good idea regardless of how the future of the GSEs is addressed, but it is particularly important if securitization is supposed to continue to play an important role in mortgage finance.

The main social benefit of this “devil you know” strategy is that it would help maintain a stable mortgage market, dominated by the 30-year, fixed-rate mortgage with a reasonable down payment. (I would argue that, prior to their foray into nontraditional mortgages, the GSEs *were* a stabilizing force in the mortgage market. That is why I believe that, if properly regulated, they could once again be a stabilizing force.) Given the adverse experience that the United States has had with other mortgage instruments, both in the Great Depression and in the recent period, this would provide comfort and reassurance. Note, however, that many other countries, including Canada, have achieved high rates of home ownership with shorter-term mortgage products.

Offsetting this benefit, there would be the risk that the GSEs would once again fail, imposing costs on taxpayers. However, such a risk is likely to exist under any arrangement in which the government tries to channel funds into mortgage lending to support the 30-year fixed-rate loan.

There are not many institutions or individuals willing to tie up funds for an uncertain period of up to 30 years. True, there are pension funds and insurance companies with a need for long-term assets. However, their appetite for 30-year mortgages is not likely to be sufficient to sustain a volume comparable to what was purchased by the GSEs. To be issued in large volume, 30-year mortgages must have a funding source that offers greater liquidity, meaning that the investor can get out of his or her position well before the 30-year final maturity date. That in turn requires funding instruments that are tradable. If the value of the underlying collateral and/or the viability of the institution must be assessed each time the instrument is traded, the resulting transaction costs will be prohibitively high. Thus, to make mortgage securities liquid, it is almost certain that a government guarantee will have to be inserted somewhere into the process.

If there is bound to be a government guarantee in any event, then the challenge of protecting taxpayers from risks is going to require a regulatory mechanism. Other mechanisms, such as the Basel international bank capital standards, or the systems used to safeguard the Federal Deposit Insurance Corporation or the Pension Benefit Guaranty Corporation, have not performed so well that they offer an attractive alternative. Other regulatory mechanisms are unproven.

In that regard, the GSE approach has a reasonable combination of theoretical justification and promising past performance. While it is true that the system cracked under extreme stresses and with the weakness of having regulatory oversight attenuated by its placement under HUD, if the lessons of this history are learned, then the taxpayer protections can be fairly robust. The shareholder-owned structure gives the GSEs an incentive to adopt internal controls in order to maintain franchise value. Having a focused regulator using capital requirements based on stress tests forces the shareholders to have sufficient "skin in the game" that management will pay close attention to risk.

It is worth pointing out that the taxpayers have not suffered from any failure of interest-rate risk management by the GSEs. Given that history, any call to restrict their operations to credit guarantees would seem perverse. It would get them out of the business that has caused no trouble, while keeping them in the business that blew up in the crisis.

Taking away the GSEs' power to hold mortgages in portfolio might be proposed with the intent of insulating taxpayers from a blow-up should Freddie or Fannie fail to manage interest-rate risk carefully. However, bear in mind that whatever interest-rate risk the GSEs are not taking will be borne elsewhere. Having the interest-rate risk management visible within the GSEs may be preferable to not knowing where or how interest-rate risk is being managed. With much of the nation's assets currently concentrated in the largest institutions, there is a good chance that if interest-rate risk causes problems, then one or more "too big to fail" banks will be affected. Ultimately, the exposure of taxpayers could be just as great or greater than if the GSEs' portfolio business had been left alone.

Attempting to channel funds to 30-year fixed-rate mortgages through a new entity or set of entities presumably would require the insertion of a government guarantee at some point. This would be trading the devil we know for the devil we don't know. We do not know what new regulatory difficulties would be posed by a different institutional structure with an embedded guarantee. However, there is little reason to expect that a new and untried regulatory mechanism will be impregnable in theory, and even less reason to be confident that it will work as intended in practice.

One of the most important bulwarks that the GSEs provide against catastrophic failure is their stock of organizational capital. Their staff and their computer systems contain a lot of embedded knowledge relevant to solving the many problems associated with linking the capital markets to the mortgage market. Creating a new institutional structure would require at least some of this knowledge to be reinvented, imposing considerable costs—and risks—on the system.

The "devil you know" strategy, as envisioned here, would limit the GSEs to supporting long-term fixed-rate mortgages for well-qualified borrowers. It would not involve them in goals to expand home ownership to borrowers with inadequate income, assets, or credit scores.

There may be a valid social goal of providing assistance to some under-qualified borrowers to purchase homes. However, the position I would take is that programs to achieve this goal ought not to operate through indirect mortgage subsidies. Instead, they should be designed as on-budget subsidies. For example, the government could give under-qualified borrowers grants that could be used to help make payments for the first three years of a mortgage. However, the interest rate on the mortgage should reflect its risk (as reduced by the existence of the grant) when priced in the market, rather than carrying an artificially subsidized rate.

Regardless of social goals, it is my view that the government should never encourage expansion of mortgage lending with low down payments. Lowering the down payment tends to amplify the housing cycle. When prices are rising, people are more apt to buy with little money down, hoping to capitalize on continued appreciation. This feeds the boom. Then, when prices stabilize, many of these speculative borrowers are unable to sustain their debt load, which causes distress sales. This worsens the downturn. If the value of home ownership is that it fosters prudence, then speculative purchasing of homes with little or no money down has to be considered antithetical to that objective.

One flaw in the "devil you know" approach will be shared by any approach that relies on a government guarantee to help channel funds into long-term, fixed-rate mortgages. That flaw is the tendency for regulatory controls on risk-taking to degrade over time. There are two sources of weakness, one financial and one political. The financial threat comes from innovation. The financial system naturally evolves mechanisms that increase the profits to be gained by exploiting a guarantee. Risk naturally flows in the direction of guarantee-backed firms.

The political weakness is that regulated firms have an incentive to lobby to create opportunities to exploit guarantees. Freddie Mac and Fannie Mae were notoriously powerful in the political realm. When Treasury Secretary Paulson put the GSEs under conservatorship, ending their lobbying was a high priority. There is a legitimate fear that if we return to the status quo ante, then the GSEs will gradually regain their formidable political prowess. This could be used to press for expanded opportunities for risk-taking and increase the perils faced by the taxpayers.

Overall, the "devil you know" strategy strikes me as the least problematic way to maintain the channels of funding between the capital markets and long-term, fixed-rate mortgages for well-qualified home buyers. This may not be a large benefit, when compared with the costs and trauma of the recent crisis and bailouts.

THE JIMMY STEWART BANKER APPROACH

Mortgage loans used to be made by local deposit-taking institutions. The loans were held by the bank. When a borrower was late with payments, the bank had local knowledge that could be used to decide the appropriate course of action. If that course of action was foreclosure, the information in the county recording office would show that the bank was the legal holder of the mortgage note and could move forward toward taking possession of the property.

What I call the Jimmy Stewart banker approach would be for the government to exit the mortgage guarantee business. The GSEs would be gradually phased out, by reducing each year for period of three to five years the upper limits on the loan amounts they can purchase. At the end of this phase-out period, their purchases would cease altogether. In addition, I would favor replacing FHA and VA mortgage loans with grants to the eligible recipients, as mentioned in the previous section. These grants would be used to make mortgage payments in the first years of the mortgage. However, this change to FHA and VA can be addressed separately from the phase-out of the GSEs.

As the GSEs are phased out, they would be replaced by whatever emerges in the market. One cannot predict with certainty what will evolve, but my expectations would be as follows.

Local banks would revert to the practice of originating and holding mortgages. That is my reason for referring to this as the Jimmy Stewart approach. Of course, if some other practice were to emerge, then it might not resemble the sort of mortgage lending that I envision here. (One other possible outcome is that the private securitization market could revive. In my judgment, this is unlikely, because the agency ratings that were the key to the private mortgage securities market have lost credibility. Another possible outcome would be the emergence of a small number of dominant national mortgage lenders, able to raise capital both domestically and internationally. These would be private analogues to the GSEs. Again, I think this is unlikely to occur, because memories of the financial crisis will make money managers reluctant to offer low-cost financing to such enterprises.)

Jimmy Stewart banks probably would offer mortgages for shorter terms than the 30-year fixed-rate mortgage that has been the standard in the United States for many years, but which is less common in most other countries. For example, the standard in Canada is a five-year rollover mortgage, in which amortization takes place on a 30-year schedule but the interest rate adjusts every five years.[4]

Again, there are other possible outcomes. Banks might find that the interest-rate swap market or the market for covered bonds (bonds issued with mortgages as collateral) is deep enough to allow them to issue 30-year fixed-rate mortgages while laying off the interest-rate risk.

The reason that I suspect that something like the five-year rollover mortgage would dominate in the absence of government intervention is that the regulatory environment in the United States no longer encourages depository institutions to have large maturity mismatches.

Until 1980, interest rates on deposits were regulated, and neither capital requirements nor deposit insurance premiums

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4 See Donald J. Lessard, "Roll-over Mortgages in Canada," in *New Mortgage Designs for Stable Housing in an Inflationary Environment*, Federal Reserve Bank of Boston Conference Volume 14, January 1975, pp. 131-141. http://www.bos.frb.org/economic/conf/conf14/conf14g.pdf

were calibrated to risk. In this environment, depository institutions had stable funding costs and they could engage in maturity mismatching without any checks. Depositors had no reason to be concerned with the institution's asset-liability strategies because the depositors were protected by insurance. The absence of risk-based capital or deposit insurance premiums left banks and thrift institutions free to try to earn the spread between regulated deposit interest rates and long-term mortgage rates.

The increase in inflation in the 1970s left many thrift institutions bankrupt. Their insolvent state was disguised by historical accounting that did not recognize the losses embedded in their holdings of long-term mortgage assets. However, as the decade of the 1980s wore on, the weaknesses in their balance sheets were exposed, and many thrifts had to be closed and their depositors bailed out at taxpayers' expense, in what became known as the S&L crisis.

The S&L crisis yielded a number of important lessons. One lesson is that it is important for regulators to be able to assess the true financial condition of depository institutions, rather than allow insolvency to be disguised by historical-cost accounting. Another lesson is that deposit insurance premiums and capital requirements have to be adjusted for risk, including the interest-rate risk that depository institutions take when they fund long-term assets with deposits. Requiring higher deposit insurance premiums and imposing higher capital requirements for greater risk would make it more expensive for depository institutions to offer long-term, fixed-rate mortgages.

By 1990, the savings-and-loan industry had shrunk drastically. Over the next 20 years, the main funding instrument for long-term, fixed-rate mortgages came to be callable debt issued by the GSEs. The call provisions enabled the GSEs to hedge much of the risk embedded in prepayment options. That is, suppose that a mortgage borrower obtains an 8 percent, 30-year loan and the GSE finances this by issuing 20-year bonds at an interest rate of 6.5 percent. Two years later, it might be the case that rates have fallen, with mortgage rates at 5.5 percent and bonds at 4.0 percent. In that case, borrowers will refinance at the lower rate, and if the GSE has failed to hedge against this risk, it will retain the 6.5 percent bond as a liability, while having only the 5.5 percent mortgage as an asset. If the 20-year bond is callable in 5 years, the GSEs exposure to prepayment risk is greatly reduced.

For the 30-year, fixed-rate mortgage to remain attractively priced in the Jimmy Stewart banker scenario, mortgage lenders would have to be able to issue callable debt without paying a large premium over Treasury interest rates. This is unlikely. Small depository institutions lack the name recognition and market credibility to tap into important sources of funds, particularly from foreign investors. In addition, their long-term-debt lacks explicit government backing (unlike their deposits, which are insured) and presumably would not carry any implicit guarantee, either. Thus, their debt would be unlikely to enjoy the AAA ratings that accrued to the GSEs.

In short, depository institutions would appear to lack access to low-cost, long-term funding. Relying on deposits to fund long-term, fixed-rate mortgages would, under prudent regulation, impose on these institutions substantial costs in the form of deposit insurance premiums and capital requirements. On the other hand, attempting to match funding by tapping the long-term debt market would be more expensive than it is for the GSEs, with their worldwide recognition and government backing.

Thus, what I expect to emerge as the GSEs are phased out is a mortgage finance system in which mortgage loans are bought and held by depository institutions. These loans will have a 30-year amortization schedule, but the interest rate will adjust about every five years. Thirty-year fixed rate loans will continue to be available, but at an interest-rate premium that is high enough that their share of the market will be much less than is the case today.

Assuming that it transpires as I would expect, this modest restructuring of mortgage credit, with more 5-year adjustable-rate mortgages and fewer 30-year, fixed-rate mortgages is likely to prove benign. As noted, many other countries have done well with mortgages with rates that stay fixed for shorter periods than 30 years.

With lending decisions made by local depository institutions, mortgage finance can arrive at a better mix of rules and judgment. We are much less likely to see an outbreak of the sort of collective insanity that infected the housing finance system from 2003 through 2007. Under that system, there emerged a demand for mortgage-backed securities that was so perversely high that mortgage originators lost any incentive to adhere to sensible underwriting standards.

One adverse consequence of a mortgage finance system that relies on securitization carried out by entities backed by the government is that it fosters extreme concentration in finance. The percentage of assets controlled by the nation's largest financial institutions was much greater during the era of securitization than was the case when savings and loans were a major factor in mortgage lending.

A high degree of financial concentration is typical in Europe and in Asia, but the United States has a longstanding tradition of preferring a more decentralized financial system. Our fear has been that large banks form a symbiotic relationship with political forces, which makes for corporatism or "crony capitalism." When finance is concentrated, government tends to become heavily involved in the allocation of capital, to the detriment of smaller entrepreneurs who lack political connections.

The problems of crony capitalism were evident with the GSEs, which were notorious for heavy-handed lobbying efforts and for hiring executives with strong political connections. By the same token, the market allocation of capital was heavily compromised, as politicians conferred advantages on the GSEs that gave them market dominance, while putting pressure on the GSEs to make financial decisions based on political considerations, most notably the affordable housing goals.

Securitization also greatly increased the role in mortgage finance of a few Wall Street firms. These firms developed a number of financial strategies which, while profitable in the short run, exposed their companies to catastrophic risks. The Dodd-Frank financial reform bill embodies a number of regulatory mechanisms intended to prevent a recurrence of this, but many economists familiar with financial regulatory history are skeptical that these mechanisms will work for very long. Instead, we believe that there is more safety in reverting to a simpler financial process that is less dependent on a few large firms.

For implementing the Jimmy Stewart banker approach, the following considerations should be kept in mind:

Regulators should monitor the distribution of interest-rate risk. They should not allow it to become concentrated in ways that put the Federal Deposit Insurance Corporation at risk. This means that banks should not be permitted to fund long-term, fixed-rate mortgages with short-term deposits without paying a stiff premium. Also, to the extent that they engage in hedging strategies that involve counterparties, regulators will need to verify the soundness of the strategies and of the counterparties. Regulators should conduct regular stress test simulations of alternative interest-rate scenarios with respect to individual insured institutions as well as with respect to the entire system, including counterparties.

As in the "devil you know" approach, Congress should back away from attempts to expand home ownership through lenient mortgage credit with low down payments. As discussed earlier, any housing subsidies should be on budget, such as in the form of grants to assist households in making mortgage payments early in the life of the loan.

With less government effort to steer funding toward mortgage finance, we should be prepared to see mortgage borrowing scaled back, as borrowers and lenders undertake transactions that reflect the true price of credit risk. Down payments should tend to be larger than they have been in recent years, and house price increases should be more restrained.

This shift away from high-leverage housing finance should be considered a benefit of the Jimmy Stewart banker approach, rather than a cost. With less of the world's capital siphoned into driving up house prices and leverage in the United States, more funds will be available for other productive investment projects. This also should help facilitate what many experts at the International Monetary Fund and elsewhere see as a long-needed adjustment in international capital flows, with the United States moderating its absorption of foreign capital and reducing its trade deficit.

CONCLUSION

I believe that the best approach to GSE reform would be to phase out the GSEs over a period of three to five years, and to allow alternative channels of mortgage finance to evolve. Regulators should pay attention to this evolution, in order to ensure that interest-rate risk does not become inappropriately concentrated, with particular concern for protecting the FDIC.

The basic approach to phasing out the GSEs would be to gradually reduce the ceilings on the loan amounts that they can

securitize. For example, if these limits were lowered by 20 percent per year, then after five years they could not longer securitize loans.

However, I would advocate eliminating some GSE activities much sooner. For example, within six months, they should stop purchasing loans for non-owner-occupied homes (including multi-family), cash-out refinances, and adjustable-rate mortgages. Their purchases of loans with down payments of less than 20 percent should be capped, either in dollar terms or as a percent of loans purchased, and these caps should fall to zero within three years.

As the market evolves, it is possible, if not likely, that the interest rate on 30-year fixed-rate mortgages will rise in relation to other interest rates. This is likely to reduce household leverage in the housing market, and it is likely to induce many home purchasers to shift toward variable-rate instruments, such as a five-year adjustable-rate mortgage.

This GSE phase-out would help to avoid a resurgence of a financial system that became both overly concentrated and overly enmeshed in political cronyism. It would make it easier for the United States to return to its traditions of decentralized, varied financial institutions.

One concern with phasing out the GSEs is that this would put upward pressure on mortgage interest rates and consequently put downward pressure on house prices. If this is an issue, then I think it would better for the government to offer a direct subsidy to for home purchases than keeping the GSEs in place indefinitely. I certainly do not believe that such a subsidy is warranted. However, the indirect subsidy implied by keeping the GSEs at their current level of involvement in the mortgage market is even less warranted.

If the possibilities of a reduced supply of mortgage funds and a rise in the relative cost of the 30-year fixed-rate mortgage are too unpalatable to contemplate, then it would be better to restore the GSEs to their previous status, rather than to create a new and different structure with government backing. The GSE model can be fixed by giving their regulator an unambiguous focus on safety and soundness, by insulating the GSEs from pressures to subsidize risky lending, and by reinstating and tightening their charter restrictions against purchasing loans with low down payments.

The worst option, in my opinion, would be to create a new government-backed system to channel funds into mortgages. Such an approach would necessarily involve the worst features of the GSE model, namely the close relationship between politics and mortgage finance, the unnatural concentration of the mortgage industry, and the inevitable deterioration of the ability of policy makers to contain or correctly price risk. At the same time, a new approach would impose a steep learning curve on both the new entities and their regulators, saddling taxpayers with unnecessarily high and uncertain costs.