The Role of the GSEs and Housing Policy in the Financial Crisis

Dwight M. Jaffee
Haas School of Business
University of California, Berkeley

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Major U.S. Housing Policy Programs
(2009 Costs in Parentheses)

- GSEs ($111 billion bailout to date and counting, $1.3 trillion purchases of GSE debt and MBS)
- FHA (self-supporting; no taxpayer funds to date)
- CRA (no direct expenditures, no quantification)
- Tax incentives for home mortgages ($143 billion)
- HUD ($38.5 billion approximate annual budget)
- Other federal and state housing programs

Housing Policy and the Financial Crisis

- The issue of housing policy as a source of the financial crisis is much less concrete than that of specific institutions/acts, e.g. GSEs, FHA, or CRA.
  - Of course housing policy was a crisis catalyst.
  - I do not find any recent changes (say post 2000) in housing policies to actively expand the incentives to make low-quality, high-risk, mortgages.
- In line with the Commission, the paper does not:
  - Attempt an overall evaluation of housing policies;
  - Provide any evaluation of policy reform proposals.

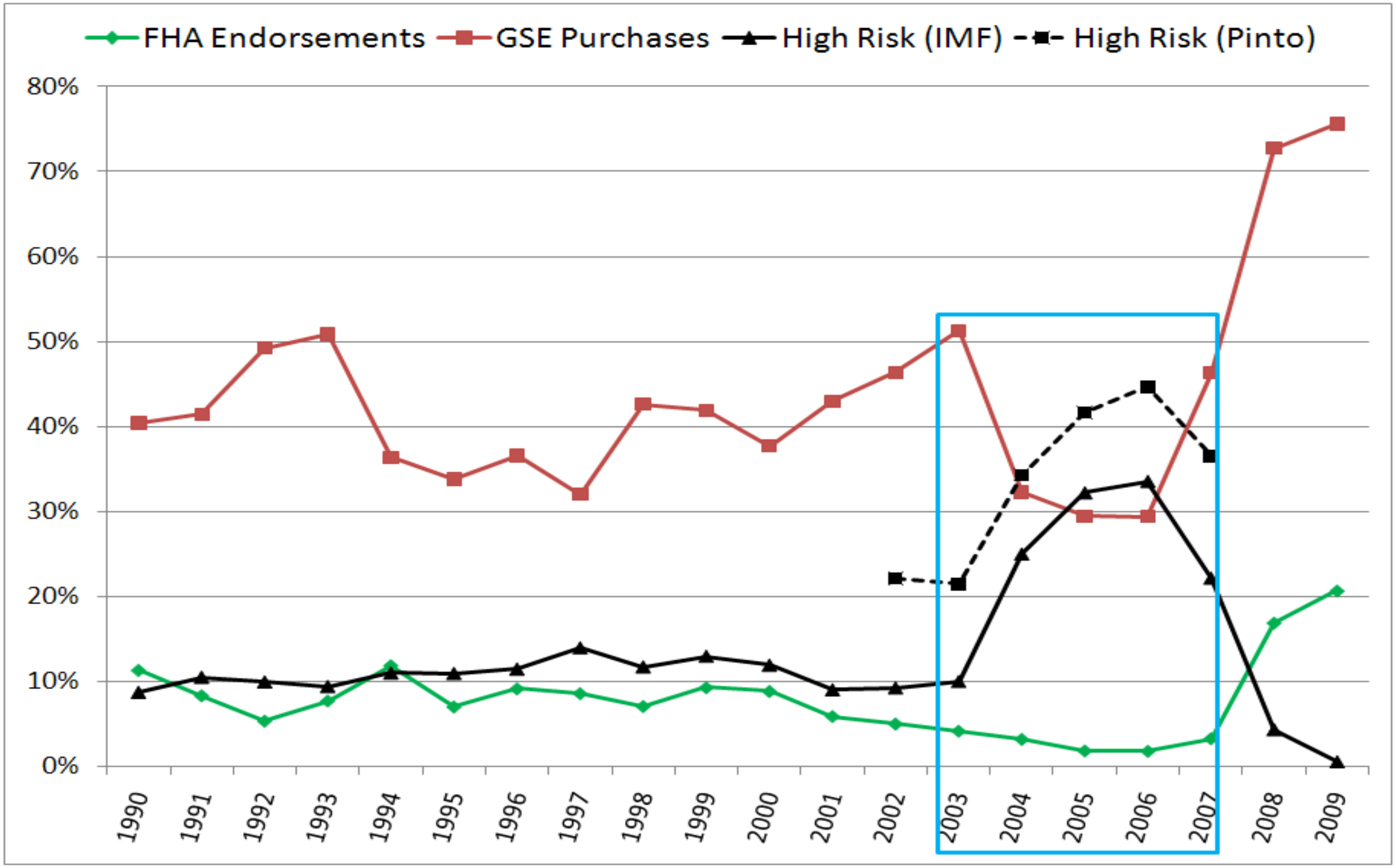
The GSEs Played a Major Role in Expanding the Financial Crisis

- GSE high-risk mortgage purchases and guarantees helped fuel the housing bubble and financial crisis.
- Evidence:
  - GSEs purchased major share of all high-risk loans.
  - High-risk loans are major share of all GSE holdings.
- Comments:
  - GSE actions unacceptable as government entity. They are supposed to stabilize, not to destabilize.
  - GSE failure is inevitable result of combining private incentives with public mission/guarantee.

Housing Goals (HGs) were Secondary Influence of GSE High-Risk Lending

- HGs were certainly complementary to GSE profits as a source of their high-risk mortgage activity.
  – But profits were the primary GSE motivation.
- Evidence:
  – The GSEs failed to meet some HGs ‘05-’08.
  – Regulator HG goals excluded high-risk loans.
  – Academic literature suggests GSE “cherry-pick” HG loans to be of the highest possible quality.
- Comment:
  – Further empirical research could be useful.

FHA, GSE, and High-Risk
Share of Total Mortgage Originations



Sources, FHFA, GSEs, Inside Mortgage Finance, Ed Pinto

GSE Activity and High-Risk Lending

Table 2: GSE Activity and High-Risk Lending

$ Billions	GSE New Business		Aggregate Lending		GSE High-Risk/	GSE High-Risk/	Agg. High-Risk/
	High-Risk	Total	High-Risk	Total	GSE Total	Agg. High-Risk	Agg. Total
	(1)	(2)	(3)	(4)	(5) = (1)/(2)	(6) = (1)/(3)	(7) = (3)/(4)
2002	328	1337	638	2885	25%	51%	22%
2003	433	2023	846	3945	21%	51%	21%
2004	418	943	1002	2920	44%	42%	34%
2005	411	919	1299	3120	45%	32%	42%
2006	448	876	1331	2980	51%	34%	45%
2007	450	1125	887	2430	40%	51%	37%

Sources: Fannie Mae, Freddie Mac, Inside Mortgage Finance, Ed Pinto, available at: http://www.aei.org/docLib/Pinto-High-LTV-Subprime-Alt-A.pdf

The FHA Played a <u>Minor Role</u> in the Financial Crisis

- Traditional FHA activity dramatically decreased as subprime lenders and GSEs dominated markets.
- <u>Evidence</u>:
  – FHA lending fell to less than 5% of overall market.
  – FHA showed no interest in pursuing these clients.
- <u>Comments</u>:
  – FHA default rates are now rising, but this is true for all U.S. mortgage lenders. FHA
  – FHA foreclosure rates remain far below subprime, just a bit above prime loans.

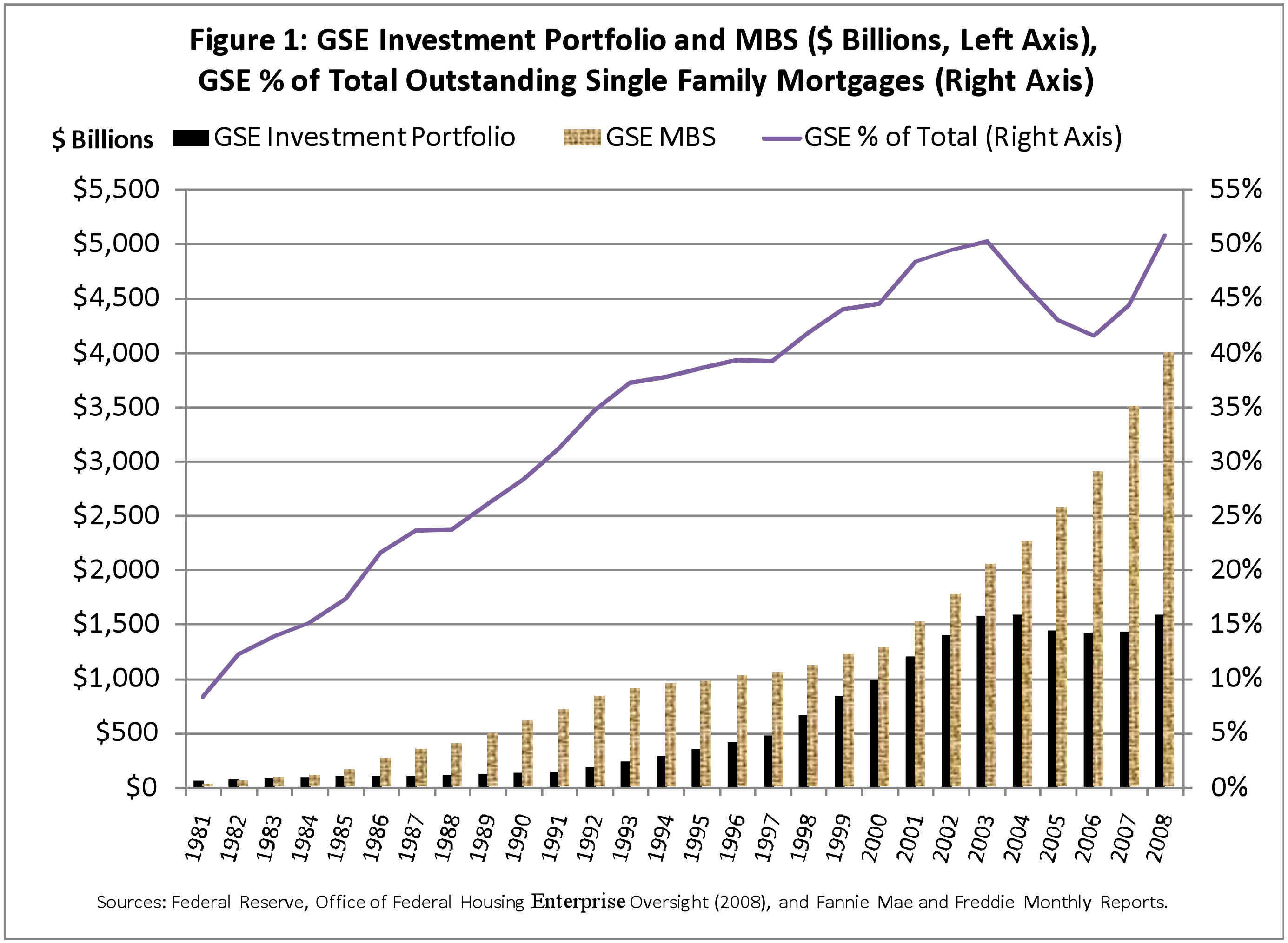
Community Reinvestment Act (CRA) Evidence Indicates No Impact

- While CRA may have "guilt by association", the evidence suggests no unique impact on financial crisis.
- Evidence (Federal Reserve studies):
  - CRA requires "safe and sound" lending.
  - Non-bank , non-CRA lenders, mortgage and financial companies, were active high-risk lenders.
  - Only 6% of 2006 subprime loans were CRA lenders.
  - "Over and under income" zip-code evidence.
- Comments:
  - Further empirical tests could be useful.

Five Other Essential Financial Crisis Causes

- U.S. trade deficit and global savings glut created a large and continuing demand for U.S. mortgage products.
- U.S. monetary policy remained benign even in the face of a housing bubble clearly visible based falling housing affordability.
- Innovations in underwriting and securitization allowed lending to concentrate on previously underserved areas.
- Commercial/investment banks held large, leveraged, and maturity mismatched high-risk loan positions.
- OTC credit default swaps on high-risk, loans far exceeded the actual volume on the actual loans.

GSE Investment Portfolios and MBS Lines



Additions to GSE High-Risk Portfolios
(As share of total GSE annual purchases)

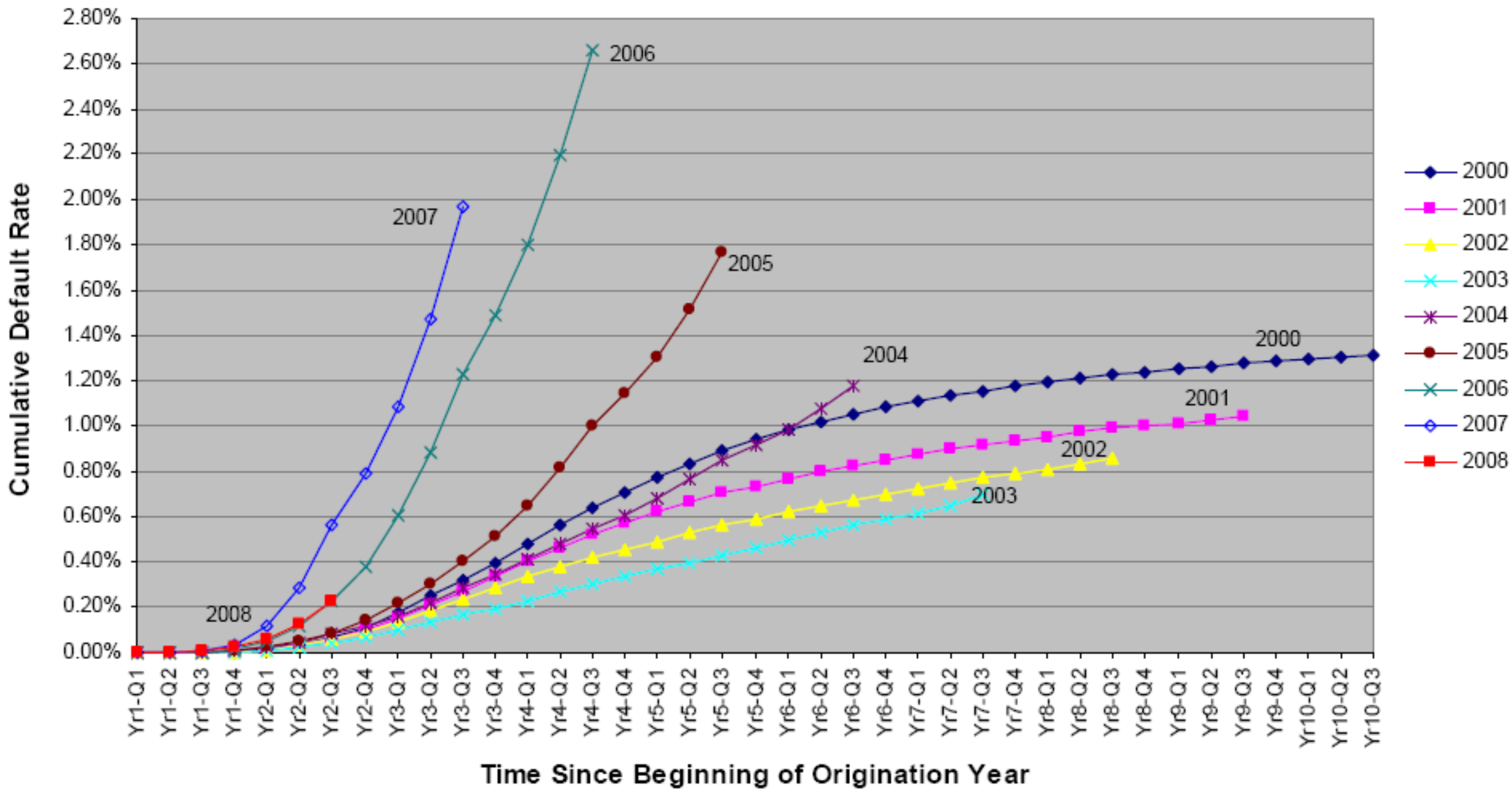
Table 3: GSE High-Risk Loan Attributes by Year of Acquisition
By share of total annual GSE acquisitions

Fannie Mae	2007	2006	2005	2004/prior	
Original LTV > 90%	19%	11%	8%	7%	
FICO < 620	7%	6%	4%	5%	
Adjustable-Rate	9%	14%	17%	8%	
Interest Only	15%	17%	10%	2%	
Condominium	11%	12%	10%	7%	
Freddie Mac	2007	2006	2005	2004	2003/prior
CLTV > 100%	37%	36%	25%	11%	4%
FICO < 620	7%	5%	4%	4%	4%
Adjustable-Rate	13%	21%	17%	14%	4%
Interest Only	20%	19%	9%	2%	0%
Condominium	11%	11%	9%	8%	5%
Sources: Credit Supplements, Fannie Mae and Freddie Mac, 2009 Q3.					

GSE High-Risk and Total Mortgages

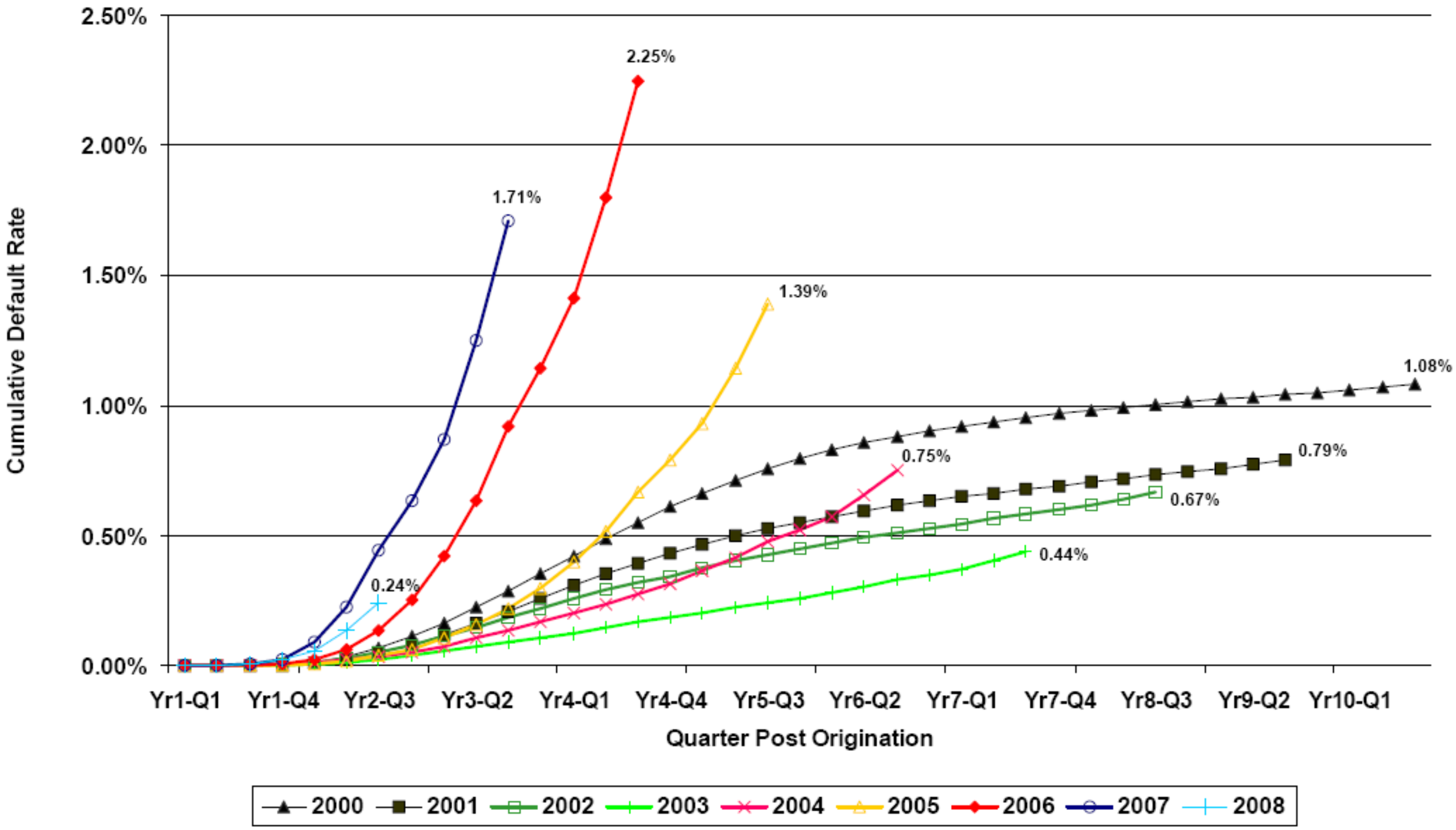
Table 1: GSE High-Risk and Total Mortgage Positions		
$ Billions of Single-Family Mortgages as of 9/30/2009		
Guaranty Book/Credit Portfolio	Fannie Mae	Freddie Mac
Subprime	$8	$0
Alt-A	259	156
Other High-Risk	591	407
Total High-Risk	857	563
Total Guaranty Book/Credit Portfolio	2796	1896
High-Risk/Total	31%	30%
Mortgage Investment Portfolio	Fannie Mae	Freddie Mac
Subprime	$22	$64
Alt-A	25	22
Other High-Risk	0	18
Total High-Risk	47	104
Total Investment Portfolio	766	784
High-Risk/Total	6%	13%
Source: 10Q and Credit Supplements, 2009 Q3, Fannie Mae and Freddie Mac.		

Fannie Mae Single-Family Default Rates by Year of Booking



Note: Defaults include loan liquidations other than through voluntary pay-off or repurchase by lenders and include loan foreclosures, preforeclosure sales, sales to third parties and deeds in lieu of foreclosure. Cumulative Default Rate is the total number of single-family conventional loans in the guaranty book of business originated in the identified year that have defaulted, divided by the total number of single-family conventional loans in the guaranty book of business originated in the identified year.

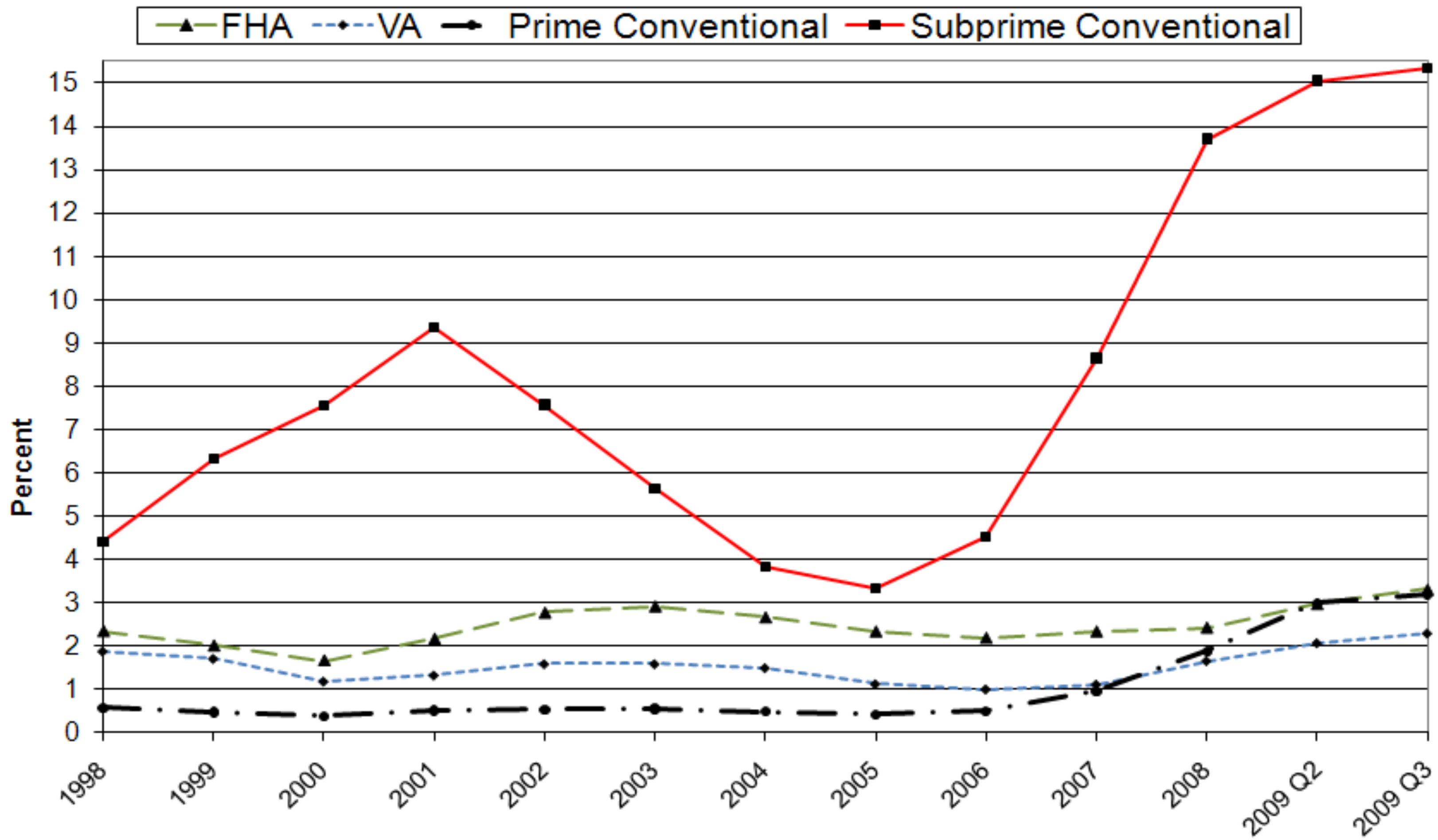
Freddie Mac Single-Family Default Rates by Year of Booking



[1] Represents the cumulative transition rate of loans to a default event, and is calculated for each year of origination as the number of loans that have proceeded to foreclosure acquisition or other disposition events, excluding liquidations through voluntary pay-off, divided by the number of loans in our single-family mortgage portfolio. Excludes certain Structured Transactions

22

Foreclosure Rates, Year-End Inventory
(Mortgage Bankers of America)



Housing Affordability Index, California
(California Association of Realtors)