Mike Baker
Head Interest Rate Shopper, The Rate Shop
Individual NMLS: 259076 Company NMLS: 2554765 State
23211 W 45th St Shawnee, KS 66226

Office: 913-213-3335
Mobile: 913-213-3335
mike@rateshopkc.com
View My Website

Fed's Powell on Urgency of Housing Finance Reform

According to Federal Reserve Governor Jerome H. Powell, the current housing finance status quo may feel **comfortable**, but it is also **unsustainable**. Powell, speaking to the American Enterprise Institute on Thursday, called urgent fundamental reform of the system "the great unfinished business of post-financial crisis reform."

He conceded that the Federal Reserve is not charged with designing or evaluating proposals for housing finance reform, but is responsible ensuring the safety and soundness of banking institutions and the stability of the broader financial system. Since a well-**capitalized** and regulated housing finance is vital to that goal, he said "We need a system that provides mortgage credit in good times and bad to a broad range of creditworthy borrowers."

While there had been some reforms addressed to pre-crisis problems, he said, there is broad agreement that the job is far from done, including resolving the ultimate status of Fannie Mae and Freddie Mac (the GSEs). The federal government's role is even greater than before the crisis, with an overwhelming majority of mortgages issued with government backing in a highly concentrated securitization market, leaving taxpayers with liability and **systemic risk**. He stressed learning both the right lessons from the failure of the old system and applying those learned post-crisis from banking system reform.

He suggests using the post-crisis reform program applied to the country's largest banks as the standards against which the housing giants should be judged. Common equity capital held by the eight most systemically important U.S. banks has more than doubled to $825 billion from about $300 billion before the crisis and **$2.3 trillion** or 25 percent of their assets are considered high-quality and liquid. They must undergo rigorous annual stress tests and file regular resolution plans that have made them significantly more resolvable should they fail. It is ironic, Powell said, that the housing finance system should escape fundamental reform efforts, given that the housing bubble of the early 2000s was an essential proximate cause of the crisis.

Housing is the **single largest asset class** in our financial system, with total outstanding residential real estate owned by households of $24 trillion and roughly $10 trillion in single-family mortgage debt. While post-crisis regulation has addressed mortgage lending from a consumer protection standpoint, the important risks to taxpayers and the broader economy and financial system have not been robustly addressed.

National Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30 Yr. Fixed	7.07%	+0.02	0.00
15 Yr. Fixed	6.45%	0.00	0.00
30 Yr. FHA	6.51%	+0.02	0.00
30 Yr. Jumbo	7.26%	0.00	0.00
5/1 ARM	7.02%	-0.01	0.00
Freddie Mac			
30 Yr. Fixed	6.86%	-0.01	0.00
15 Yr. Fixed	6.16%	+0.03	0.00
Mortgage Bankers Assoc.			
30 Yr. Fixed	7.02%	-0.05	0.65
15 Yr. Fixed	6.60%	-0.15	0.55
30 Yr. FHA	6.87%	0.00	0.92
30 Yr. Jumbo	7.18%	-0.03	0.54
5/1 ARM	6.45%	+0.08	0.81

Rates as of: 6/28

Recent Housing Data

		Value	Change
Mortgage Apps	Jun 12	208.5	+15.58%
Building Permits	Mar	1.46M	-3.95%
Housing Starts	Mar	1.32M	-13.15%
New Home Sales	Mar	693K	+4.68%
Pending Home Sales	Feb	75.6	+1.75%
Existing Home Sales	Feb	3.97M	-0.75%

		Value	Change
Builder Confidence	Mar	51	+6.25%

The old housing finance system did its job for many years. Through standardization, structuring securities across a broad range of risk, and guaranteed MBS it brought greater **liquidity** to mortgage markets, and made those mortgages more affordable. That either GSE would ever fail to honor its guarantee seemed remote but the issue lingered in the background along with the question of whether Congress would allow the GSEs to fail. The law notwithstanding, investors priced in an implicit federal government guarantee behind GSE obligations. This mean they often didn't do careful due diligence on the underlying mortgage pools, enabling lower lending standards.

Powell believes the system's **bad incentives** led the GSEs to assume ever greater risks. They became their own advocates, providing substantial financial support for political candidates who supported their agenda. Legislative reforms in the 1990s led to expansion of the GSE's balance sheets to enormous size, underpinned by wafer-thin slivers of capital, driving high shareholder returns and high executive compensation, and ever more lax lending conditions including the growth of Alt-A, low doc, and no doc loans, all contributing to the catastrophic failure of the housing finance system.

Powell **acknowledged** that the housing sector is healthier and, in some respects, safer than before the crisis. Housing prices have recovered in most of the country, mortgage delinquencies are back to pre-crisis levels and mortgage credit is "available and affordable for strong borrowers." There has also been meaningful progress toward reforming the old system. The GSEs retained portfolios have declined to about half of their pre-crisis size, and they have laid off about $50 billion of their credit risk onto private capital. The creation of a Common Securitization Platform should strengthen the GSEs' securitization infrastructure and enhance competition. In addition, new regulations have worked to encourage sound underwriting of mortgage loans.

Yet, there remain many **challenges**, Powell said. Despite the significant role they play there is no clarity about the GSEs' future. When he put them into conservatorship, then-Treasury Secretary Paulson viewed it as a 'time out' to stabilize them while deciding their future rule and structure. Nine years later the federal government dominates the housing sector even more; the GSE's, FHA, and the VA have a combined share of about 80 percent of the purchase mortgage market, with the remaining 20 percent held by private financial institutions. After reaching nearly 30 percent of the market before the crisis, private-label securitization has dwindled to almost nothing today.

Today the GSEs remain in conservatorship, with associated contingent liabilities (estimated at over $125 billion) to US taxpayers. Fannie and Freddie have remitted just over $270 billion of profits to the Treasury, more than paying back the government's initial investment, but their current contracts with Treasury mandates their capital to decline to zero by January 1, 2018. They have more than **$5 trillion of MBS** and corporate debt outstanding, widely held and receiving various forms of special regulatory treatment. The GSEs also serve as important standard-setters and significant counterparties to other firms.

Borrowers with lower credit scores face **significantly higher standards** and lower credit availability than before the crisis, Powell said, and while we don't want to return to the poor underwriting standards used pre-crisis, it may also be that the current system is too rigid, limiting credit availability to some creditworthy households.

Market forces should be employed to **increase competition** and help drive innovation. He cautioned that, as memories of the crisis fade, the next few years may present the last best chance to finish the job.

The most obvious and direct step toward housing finance reform would be to require **ample amounts of private capital** to stand between housing sector credit risk and taxpayers and to support housing finance activities, as in the banking system. We should also strive for a system that can continue to function even in the event of a default of any firm. No single housing finance institution should be too big to fail.

Greater amounts of private capital could come through the entry of multiple private guarantors to participate in risk-sharing agreements, or through expanded use of credit-risk transfers although there may be limits to the private sectors appetite for such risk.

Both public and private sectors have struggled with ways to appropriately price the insurance of catastrophic risk and how to smooth the consistent collection of premiums to ensure against enormous payouts that may only happen once or twice a century. The GSEs have successfully transferred some credit risk to the private sector, but not much of the catastrophic credit risk, arguing that doing so is not economical.

Powell said Congress has thus far failed to enact several promising initiatives, but "the air is again thick with housing finance reform proposals." Considering the implications he set forth earlier for the Federal Reserve's oversight of financial institutions, and the stability of the U.S. economy, he offered the audience five principles for reform which he said were based on the lessons learned from the old system's collapse, and from the experience of post-crisis bank reform.

1. Do as much as can be done to make future housing **bailouts** a remote possibility. Housing can be volatile and often at the heart of financial crises, but its institutions are not structured to reflect that. As with banks, the housing finance system must continue to function, even in the face of significant price declines and severe economic conditions. Attracting large amounts of private capital is important to that goal.

2. Many of the current reform proposals incorporate a **government guarantee**, but only to take effect after a significant stack of private capital is wiped out. If Congress opts for a guarantee, it should be explicit and transparent and apply to securities, not to institutions. Reform should not leave us with any institutions that are so important as to be candidates for too-big-to-fail.

3. Reform should promote greater **competition**. At present, there is no way private firms can acquire a GSE charter. This is the equivalent of having only two banks with federal deposit insurance. Greater competition would decrease the importance of the GSEs, spur innovation and give homebuyers greater choice. However, this requires a level playing field that allows broad secondary market access.

4. Consider **simple approaches** that restructure and repurpose parts of the system's existing architecture. Completely redrawing the system may not be necessary and could complicate the search for a solution.

5. Identify and build upon areas of **bipartisan agreement**. At this late stage, we should not be holding out for the perfect answer. We should be looking for the best feasible plan to escape the unacceptable status quo.

Powell concluded with two reasons he sees this as a good time to address the housing system's shortcomings. The economy and the housing sector are healthy and fundamental structural changes would be disruptive during difficult economic times. Second, memories of the crisis are fading and we are at risk of settling for the status quo--a government-dominated mortgage market with insufficient private capital to protect taxpayers, and insufficient competition to drive innovation. There is a serious risk, if not a likelihood, that this could persist indefinitely, leaving our housing finance system in a semi-permanent limbo. Fortunately, there is a growing menu of reform options available for public vetting. And there appear to be areas of broad agreement among them.

Real Talk

At The Rate Shop, we're not your average mortgage banker. We specialize in bringing you ridiculously low interest rates that will make you wonder what the other guys are doing. In fact the ONLY objection we ever hear is “your rates sound too good to be true”. Well they’re not, and here is why…

After 15 years in the retail banking world I was frustrated with the high interest rates that came from that business model. As I looked around at all the bloated layers of management and their expensive salaries and the overhead of running a larger company (think rent costs, employee health and benefit costs, payroll taxes, and on and on) it dawned on me that I was a part of the problem, and the solution, for me at least, was so easy to see.

Start my own mortgage brokerage shop. No expensive executive salaries, no expensive building to pay rent at, no unnecessary employees and all the costs that are associated with that. What happens when you cut out all the fat? You can provide lower rates and lower closing costs. It’s simple. Now here is the best part, you still get great service from a local Kansas City Lender. My mission is to let everyone know that low rates and great customer service are NOT mutually exclusive.

Thanks for coming along on this journey where Low Rates meet Great Service. The two do NOT have to be mutually exclusive. It’s just a lie that the big box mortgage companies have been telling you for years. Don’t believe me? Give me a call or shoot me a text on my personal cell phone today and compare my rates and costs up against any other lender in the country, and be prepared to be blown away.

Mike Baker