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Statement of the Shadow Financial Regulatory Committee on

Financial Turmoil and Implications for Mortgages and Related Mortgage Securities

September 17, 2007

Turmoil in the financial markets has dominated the news during the past several weeks. What began as a subprime mortgage problem has become a general problem for securitizations as a whole, including mortgage-backed securities (MBS), asset-backed securities (ABS), and asset-backed commercial paper (ABCP). Confidence in the technology of measuring and managing risk in securitizations has declined as investors have experienced significant losses. Some mortgage intermediaries have been forced to exit the market and the capacity of the financial system to absorb risk has been reduced. Many observers and policy makers have called for measures to counteract the financial dislocations related to this turmoil.

The current downturn in the mortgage and housing markets is not unusually severe when compared with previous housing cycles. Subprime mortgage delinquency rates are still below those of 2001-2002, and the decline in residential investment by households relative to GDP over the past several months is not unusual when compared to previous housing cycles, and much less than the declines experienced, for example, in the late 1970s and late 1980s.

While the subprime turmoil has affected the level of interest rates on short term investments, it is also true that problems in securities markets have largely been confined to securitization products (e.g., ABCP rather than other parts of the commercial paper market) and that dislocations in interbank lending markets in Europe have largely been resolved by brief and targeted central bank liquidity injections. The problems in securitized instruments are persisting because of continuing uncertainties regarding the reliability of risk measurement practices and where losses will ultimately reside. In particular, there has been a loss of market confidence in both the ratings agencies' measures of risk and the risk measures generated by internal models.

In Statement No. 245, issued May 7, 2007, the Committee recognized the burgeoning problems in the subprime market and the dislocations that were likely to arise. The Committee also disagreed with the call for federal intervention into mortgage markets, either through direct subsidies, or indirect subsidies channeled through Fannie Mae and Freddie Mac, and stated that any efforts to assist borrowers should be treated and funded at the state level. Aggressive bailout policies would be counterproductive, because they would only forestall necessary adjustments and risk encouraging a new wave of poor lending and borrowing practices. We proposed, instead, to focus on improving disclosure in the mortgage application process, as a means of empowering consumers to avoid unsafe borrowing.

The deepening problems that we foresaw in our May statement as necessary market adjustments to portfolios and the re-pricing of risks have come to pass, and alongside those predictable adjustments, the calls for federal government intervention have intensified. We continue to believe that aggressive bailouts of mortgage-related investors or mortgage borrowers – either in the form of government willingness to lend at subsidized rates or to lower down payment requirements on Federal Housing Administration (FHA) loans – would be counterproductive. FHA loans under current laws and regulations only require a 3% minimum down payment, which the Committee believes is already sufficiently low and should not be relaxed further. We also note that substantial increases in the willingness and ability of lenders to reduce debt service or expand maturity as a means of "mitigating" foreclosures of delinquent mortgages began in the late 1990s and expanded in the early 2000s as the result of changes in the policies of Fannie Mae, Freddie Mac, and the FHA. Thus, compared to previous episodes of increased mortgage delinquency, current mortgage market borrowers face a much more flexible and less costly set of alternatives for dealing with delinquency problems.

Some limited government encouragement of market workouts between delinquent borrowers and their mortgage lenders may make sense, but only if severely limited and tied to bilateral negotiations as opposed to broad-based government mandates. For example, the proposal to exempt from income taxation any debt forgiveness obtained from mortgage renegotiation is being promoted as a helpful incentive for socially desirable mortgage renegotiation. While its merits are disputable, if the proposal is adopted, the benefits should strictly targeted and restricted to a limited group of recipients, such as low and moderate income homeowners seeking to retain their primary residences.

The financial turmoil has exposed two structural problems that unnecessarily hamper proper risk assessment in MBS, ABS, and ABCP. By addressing the following issues, policy makers could substantially improve the long-run quality of the markets for securitized mortgages and related instruments: (1) the regulatory outsourcing of risk assessment through the use of rating agencies' ratings of the debts issued by ABS, MBS, and ABCP, and (2) the lack of proper disclosure to investors of mortgage loan mitigation practices by Fannie Mae, Freddie Mac, and the FHA.

The use of external risk assessments by banking supervisors raises other questions. Regulated financial institutions (banks, mutual funds, insurance companies, and pension funds) are among the most important purchasers of MBS, ABS, and ABCP, and portfolio regulations establish minimum "investment grade" letter ratings for the debt instruments that these institutions are permitted to hold. Because fees to rating agencies are now paid by those seeking to issue securities, rather than by investors, this has changed the client base demanding a rating from at risk investors looking for a conservative opinion to issuers willing to pay for an inflated rating. The growing demand for assets gives rating agencies a strong incentive to inflate ratings (that is, to overstate quality and understate default risk) because doing so expands the range of permissible, and marginally higher yielding, assets for regulated institutions. This, in turn, increases the fees they receive for providing ratings and structuring asset pools into specific tranches.

The Committee has noted in previous statements that the outsourcing of risk assessment of regulated financial institutions to unaccountable rating agencies is not an effective substitute for proper risk assessment by market participants at risk (i.e., debt holders) or by prudential supervisors. We have long advocated the use of uninsured subordinated debt requirements for banks to ensure that continuous risk assessments are made by informed and properly incentivized agents, who share their views of risk through publicly observable prices (see Statement No. 168).

To the extent that regulators continue to rely upon rating agencies' opinions, the Committee suggests that regulators use a more meaningful measure of risk, which is "expected loss" (i.e., the product of the estimated probability of default and the loss given default) and not the letter grade provided by the agency. Research has shown that letter grades deviate meaningfully across securities types from agency calculations of delinquencies or expected loss.

With respect to appropriate disclosures to mortgage investors, mitigation of mortgages has increased substantially as the result of the above mentioned reforms instituted by Fannie Mae, Freddie Mac, and FHA, and the result has been a significant decline in the percentage of delinquent mortgages that experience immediate foreclosure. Mitigation may be a sensible policy, since it avoids costs of liquidation. But because these practices have not been disclosed to the market, mitigation has produced an invisible decline in the average quality of "performing" mortgages. FHA data on aggregate mitigation experience indicate that a significant number of mitigated mortgages end up defaulting again and experiencing ultimate foreclosure. Thus, mitigation often masks remaining unresolved credit problems and is opaque to the investors in these assets and the securitized products derived from them. The Committee believes that mitigation policies and experience should be a key element of disclosure available to prospective investors.

Finally, Freddie Mac and Fannie Mae and other have proposed that these GSE's be freed from limits on their portfolio investments and also be able to expand the size of the mortgages upon which they can issue guarantees. In both cases, the Committee believes that such changes will not address the problems in the subprime markets nor would they substantially improve conditions in mortgage markets more generally, relative to the risks they pose to the taxpayer. These GSEs were not originally intended to be primary mortgage investors and making a secondary market in mortgages can be accomplished through their securitization activities. These institutions borrow in markets to fund their mortgage investment activities with liabilities implicitly guaranteed by the US government, with the associated moral hazard incentives. Expanding the size of loans eligible for GSE guarantees focuses on a small part of the mortgage market that involves the purchase of expensive houses by relatively wealthy individuals. This is hardly a segment of the market that is in need of implicit federal subsidies or support.