

U.S. needs to reset mortgage mess

Antony Currie, Reuters - Tuesday, Aug. 17, 2010

Washington faces a mortgage market conundrum. A conference today hosted by the U.S. Treasury is supposed, finally, to start addressing what to do with Fannie Mae and Freddie Mac. But the bunch of fixes proposed by regulators and lawmakers in attempts to make private home loans safer is causing other problems.

Assuming the eventual goal is to sharply reduce the role of government agencies in mortgage finance, then there's a matching need to increase private-sector funding for mortgages. The most obvious difficulty is crowding out by the subsidized agencies. But there are other structural barriers to private lending, too.

The most glaring case of crowding out is in so-called jumbo mortgages, where borrowers may meet all other criteria to conform with Fannie and Freddie standards except that the loan they want is too large. Until the crisis, the maximum loan the GSEs could guarantee was US\$417,000 for single-family properties. Now it's US\$730,000.

Neither banks nor asset-backed investors — both of which increasingly want to hold loans of this kind -- can compete with the lower funding costs the government agencies enjoy.

Another example is the subprime market. The Federal Housing Administration has made it almost impossible for banks to consider jumping back in, however cautiously. The agency made US\$451-billion in loans last year, accounting for a quarter of all new U.S. mortgages. Not only are its funding costs lower than the private sector's, it is also using methods discredited by the housing crunch, such as taking only minuscule down payments from borrowers. In that regard, its decision last week to increase the minimum equity requirement to 10% is encouraging.

If the government loosened its grip on these parts of the market, banks should be able to pick up the slack, especially in jumbos. Bank lending alone, however, would struggle to compensate for any broader moves to shrink Fannie, Freddie and the FHA.

That's because even with the inevitable somewhat higher mortgage interest rates, there's simply not enough room on U.S. banks' books. Over the past decade, lenders' balance sheets have rarely

accounted for more than 15% of U.S. mortgage financing, according to a report last year from the Federal Reserve Bank of San Francisco.

If banks had held on to all mortgages extended last year rather than selling them on, they would have needed an extra US\$180-billion in equity capital, assuming a 10 times leverage multiple. And that's one year — to take on the entire US\$5.8-trillion of mortgages Fannie and Freddie currently own or guarantee, the banking system would need to go in search of US\$580-billion of fresh ammo.

That's where alternative forms of financing come in — including securitization, in which home loans are repackaged and sold to a broad range of private investors. But recent actual and mooted regulatory changes have bred uncertainty. The Federal Deposit Insurance Corp., for example, is still debating the rules on what happens if a lender fails. Securitized assets ought to be protected from a bankruptcy, but early drafts called this into question and have spooked the market.

Another logical-seeming new rule requires that lenders retain risk in their securitizations. As the argument goes, that should keep them more mindful of their lending standards. That's also supposed to be one of the strengths of covered bonds, the primarily European funding tool that creates extra funding capacity for banks while keeping mortgages on their balance sheets. Congress recently passed legislation that should make it easier to establish covered bonds in the United States.

Yet plenty of U.S. lenders, including HSBC, Wachovia and Washington Mutual, kept mortgages on their balance sheets that have since turned horribly sour. Meanwhile, the existence of covered bonds did nothing to prevent housing bubbles inflating and bursting in Spain and the U.K.

More worrying, though, is the interplay of U.S. accounting and capital rules. The way these are currently shaping up, lenders will often be forced to hold reserves against the entirety of a securitized package of mortgages despite retaining, say, only a 5% slice. That will make securitization expensive and won't increase the amount of capital available to fund mortgages much, if at all.

In short, reforming Fannie and Freddie will be even more of a struggle unless constraints and anomalies affecting the private market are also dealt with. Otherwise, attempts to wean the industry off the agencies could leave mortgage funding scarce.