Center for American Progress

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The Perils of Privatizing the U.S. Mortgage Finance System

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Introduction and summary

The U.S. Congress and the Obama administration are now earnestly engaged in the complicated process of reforming our nation's mortgage finance system. The decisions they make will have enormous impacts on the shape of the U.S. financial markets and may well decide whether homeownership remains a part of the American Dream for middle-class families or instead a distant hope for only the wealthy.

Increasingly, many conservatives are calling for the privatization of the mortgage markets, advocating the winding down of the mortgage giants Fannie Mae and Freddie Mac without any replacement. This privatization argument ignores the fact that the modern U.S. banking system, which provided an unprecedented degree of stability and prosperity from the 1940s through the early 2000s, was dependent on a strong government role, including a high degree of risk regulation and a government backstop— in the form of a federal guarantee for deposit insurance and a federal guarantee for mortgage-backed securities issued by Fannie and Freddie.

In a white paper published late last year by the Center for American Progress, "Future of Housing Finance Reform," I demonstrated that privatizing the mortgage markets would result in some fairly radical changes, including:

- Limited availability of long-term, fixed-rate mortgages
- Sharp increases in the costs of mortgages
- Large reductions in the availability of mortgage credit
- A higher systemic susceptibility to housing bubbles
- A lack of mortgage credit during downturns

In response to these facts, advocates of privatization largely responded with two arguments. First, they criticized the alternative to privatization—namely, providing a government guarantee of some kind on home mortgages—claiming that this would provide a major benefit to the banking industry. Second, privatization advocates argued that the private sector can provide 30-year fixed-rate mortgages and broad liquidity—despite the large amount of evidence to the contrary. They point to the historic availability of affordably priced 30-year fixed-rate loans (at least up until the financial crisis) in the so-called jumbo market, which serves borrowers seeking high-balance loans, as evidence that a privatized system can meet the needs of the broader mortgage market.

Both of these claims are flawed. The first claim—that an explicit government guarantee would unduly benefit the banking industry—is wrong in several ways. First, it ignores the fact that a government guarantee already exists for "too big to fail" financial institutions, as evidenced by both the 2008 bailouts (both the Troubled Asset Relief Program and the various Federal Reserve programs) and recent studies indicating that these firms enjoy a "too big to fail" subsidy in their cost of funding.[1]

Second, it ignores the fact that these same "too big to fail" financial institutions would be the primary beneficiaries of a privatized mortgage finance system because they are the only ones with either the securitization infrastructure or excess balance sheet capacity to significantly increase their mortgage financing activities. As such, privatizing the U.S. mortgage market would deliver up to these big financial institutions a major windfall, further cementing their status as "too big to fail," particularly given the high systemic importance of residential mortgage debt.

Finally, this claim ignores the fact that a well-designed explicit government guarantee, with large buffers against loss such as an insurance fund and high capital requirements, would be far more onerous for these large financial institutions than the free, unpaid guarantee that they already enjoy by virtue of being "too big to fail."

In the aggregate, then, privatization would provide a far greater benefit to the banking industry and pose a far greater risk to taxpayers than an explicit, well-designed government guarantee. To the extent that privatization led to "too big to fail" banks taking on a greater role in the $10 trillion U.S. residential mortgage market, this would increase taxpayer exposure to losses due to the implied guarantee on the liabilities of such firms, without any corresponding increase in the protections (stringent regulation, an insurance fund) that ordinarily accompany such a guarantee.

The second claim—that the jumbo mortgage market proves that a privatized system would widely provide good mortgage products such as the 30-year fixed-rate mortgage—is also deficient. The jumbo market provides mortgages, for the most part, to high-income, high-wealth borrowers. No one disputes that purely private markets can serve this market well, just as they have always done.

In fact, our current system explicitly assumes that more wealthy Americans can receive mortgage finance without a government guarantee, which is why there are dollar limits on the loans Fannie and Freddie can securitize. But because the jumbo markets historically served this limited market segment does not provide any evidence it can serve the much larger "conforming market" of home mortgages currently served by Fannie and Freddie.

Conversely, there are many reasons to believe the jumbo market would not provide either broad liquidity or continue to provide 30-year fixed-rate mortgages if we privatized the U.S. mortgage markets. As our white paper demonstrates, the experiences we have had with purely private mortgage markets, including during the pre-New Deal era as well as in the contemporary commercial real estate market, give us some strong data points indicating that a privatized mortgage market would lead to sharp reductions in liquidity and the unavailability of the 30-year fixed-rate loan for most Americans.

The jumbo market generally favors adjustable-rate mortgages over 30-year fixed-rate loans, originating more ARMs than fixed-rate mortgages in most years, and far more so than in the conforming market served by Fannie and Freddie. To the extent that the jumbo market has offered 30-year fixed-rate loans, these have been integrally tied to the government-supported segment of the market.

Obviously, Fannie and Freddie historically set a market standard in providing affordably priced 30-year fixed-rate mortgages, one the jumbo market must compete with. Fannie and Freddie also historically provided the market infrastructure that facilitates the availability of affordable jumbo 30-year fixed-rate loans. Jumbo lenders have largely hedged these mortgages through the deep and liquid forward markets for Fannie and Freddie securities.

In short, if we privatized the market served by Fannie and Freddie, we would be removing both the incentive *and* the ability of private lenders to offer affordable 30-year fixed-rate loans.

Moreover, there are serious reasons to question the scalability of private mortgage finance in the absence of a government role. Currently, there are two main sources for private mortgage financing:

- Deposit-backed loans offered by banks and thrifts, which of course are also guaranteed by the federal government through the Federal Deposit Insurance Corporation

- Private-label mortgage securitization, the Wall Street-dominated process of bundling mortgages and issuing securities to investors based on the cash flows from those mortgages

It is highly unlikely either of these are capable of accounting for a significant increase in mortgage financing, for reasons explained in detail in the pages that follow. In the absence of a government guarantee, it is difficult to understand where mortgage liquidity would come from, with the near-certain outcome being a major reduction in the availability of mortgage loans.

Certainly, there were major problems with Fannie and Freddie—problems that must be addressed as Congress and the Obama administration move ahead with housing finance reform. But policymakers should also acknowledge the significant benefits provided by these entities as well. The clear and sensible policy solution should be to try to keep as many of the benefits we enjoy as possible while eliminating the problems.

Privatizing the mortgage markets would do exactly the opposite, eliminating the benefits provided by the current system, among them broad liquidity and the availability of consumer-friendly products like the 30-year fixed-rate loan, while entrenching or even worsening problems such as taxpayer risk, implied government guarantees for private financial institutions, and "too big to fail."

Advocates of privatization provide sound advice in warning policymakers to avoid recreating the government-sponsored entities. But at the same time, policymakers should be even warier of recreating the private-label securitization system of the past via complete privatization of the U.S. mortgage market, which was after all far more culpable in causing the recent mortgage crisis and the taxpayer losses that resulted.

Privatizing the mortgage markets would increase the "too big to fail" problem

As we learned from the series of banking panics that regularly occurred prior to the Great Depression of the 1930s, banking poses an enormous amount of systemic risk. Bank failures can quickly lead to bank panics, causing an enormous loss of wealth and economic devastation. This is why governments "bail out" their financial institutions in times of trouble—they believe the cost of letting a financial panic go unchecked is much higher than the cost of the bailout. This is particularly true for residential mortgage lending, given the economic and social importance of housing.

Exacerbating the systemic risks posed by mortgage banking, we have the contemporary problem of "too big to fail"—when financial institutions are so large and interconnected that the unsupported failure of a single one of them would, it is believed, cause the downfall of the global financial system, leading to major economic distress. Because of this "too big to fail" status, large financial institutions are believed to enjoy an implicit government guarantee on their obligations. This taxpayer guarantee provides significant subsidies to the biggest banks, as they enjoy significantly lower funding costs than smaller financial institutions.[2]

It is these largest financial institutions that would benefit the most if we adopted either of the Obama administration's privatization proposals, as was recently pointed out in a note from MF Global.[3] Under either of the privatization approaches, we would be asking private lenders to take on the $5.5 trillion in mortgage financing—primarily for working- and middle-class households—that is currently provided by Fannie and Freddie. To the extent such lending occurred, it would be financed either by lenders willing to hold loans to maturity on their balance sheets, or from the private-label securitization of mortgages. In both areas, "too big to fail" financial institutions have a decided advantage over their smaller competitors.

The six largest U.S. financial institutions—Bank of America Corp., Wells Fargo & Co., JP Morgan Chase & Co., Citigroup Inc., Goldman Sachs Group Inc., and Morgan Stanley—account for more than a third of all balance-sheet-financed residential mortgage lending. This concentration is increasing due to their lower cost of funding and excess balance sheet capacity. To the extent that privatization led to increased balance sheet lending, this would unduly accrue to these "too big to fail" banks.

These same six firms, which currently hold about $9.275 trillion in assets, have even greater market power in the investment banking sector, particularly given the consolidation that occurred in the aftermath of the 2007-2008 financial crisis, which included the mergers of Chase and JP Morgan, Bank of America and Merrill Lynch, and Wells Fargo and Wachovia, among others. Thus, they are likely to dominate any private-label securitization that may reemerge from the crisis.

In short, privatization of the mortgage finance system would result in "too big to fail" financial institutions becoming even bigger and more systemically important. It would also encourage greater concentration in the financial system. As a result, the taxpayer guarantee enjoyed by these institutions—a guarantee that is given for free—would be even more pronounced, providing greater advantage to these institutions.[4] Lest we forget, it was these firms that caused the financial crisis.

Privatizing the mortgage markets would shrink liquidity and harm consumers

It is difficult to predict exactly what would happen if we privatized the mortgage finance system because the "purely private" mortgage system has been so rare in modern history. Since the New Deal, the federal government has guaranteed most of the U.S. residential mortgage market, either through federal deposit insurance or guarantees on securitization. And there are no contemporary examples of an advanced economy that does not provide significant levels of government support for its mortgage markets.[5]

That being said, the few examples of privatized mortgage systems that have existed strongly suggest that in the absence of a government guarantee there would be some extreme and undesirable consequences. In "Future of Housing Finance Reform," for example, I noted that the "democratization" of the U.S. housing finance system, in which accessible mortgage finance (such as the 30-year fixed-rate loan) was made available to working- and middle-class households, was entirely a product of the New Deal banking and housing reforms.

Prior to the New Deal, mortgages were only available to higher-income and higher-wealth borrowers, and even then only on terms that were very friendly to lenders and extremely onerous for consumers, with high floating interest rates, short durations, interest-only or negative amortization (the loan balance was not paid down or even grew higher over time), high down payments (typically 50 percent), and featuring bullet payments of principal when the loan came due (forcing the borrower to refinance or pay off the loan every few years).[6]

As a result, homeownership hovered at around 40 percent from the late 1800s to the Great Depression, a remarkably low figure considering the widespread availability of cheap land (the federal government was literally giving away land during this period, for example with the Homestead Act of 1862 and the Enlarged Homestead Act of 1909 among other programs).

While the pre-New Deal mortgage system is obviously a very dated example, it is striking that in some important ways, it resembles the current (smaller) market for commercial real estate finance, which largely lacks government support.[7] As Special Advisor to President Obama and Harvard Law School Professor of Law Elizabeth Warren notes, commercial real estate loans today generally have terms that closely resemble pre-New Deal residential mortgages: short term, interest only, high interest rates, and high (often 50 percent) down payments. And of course these loans are generally reserved for higher-wealth borrowers.

More recently, we saw the private-label securitization market of the past decade hewing to this familiar pattern, as it displayed a strong bias in favor of riskier adjustable-rate mortgages over safer long-term, fixed-rate loans. In total, ARMs accounted for 70 percent of all mortgages financed by private-label securitization from 2001-2008, compared to 12 percent for loans financed by Fannie and Freddie).[8]

These examples all point to the same conclusion: Privatization would lead to a sharp reduction in mortgage liquidity and a transition away from consumer-friendly products, including the 30-year fixed-rate mortgage.

The lack of available capital for a privatized system suggests sharp liquidity reductions

A privatized mortgage system would also face difficulties in attracting investment capital, making it likely that such a system would see a severe reduction in mortgage liquidity, and thus the availability of mortgages to consumers.

Currently, most U.S. mortgages are financed by the purchase of securities guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae (called "agency securities").[9] The interest-rate-sensitive investors who purchase these government-guaranteed securities are predominantly made up of foreign central banks, fixed-income investors such as pension funds, and regulated financial institutions, as the Federal Reserve's Flow of Funds reports show.

These investors typically purchase U.S. government agency securities because of investment objectives (often required by charter or law) or regulatory incentives. The attraction of these government-guaranteed securities to investors and regulators is they bear essentially no credit risk, don't require costly and time-consuming due diligence, and are very liquid because they can be resold at any time into the secondary markets.[10]

Conversely, mortgages that are not backed by the federal government, which bear credit and interest-rate risk and require independent due diligence, are financed either by lenders who hold loans on their balance sheet or through private-label securitization, which are financed by credit-risk-sensitive investors.[11] Since the savings and loan crisis of the late 1980s, such nonguaranteed lending accounted for 12 percent to 25 percent of conventional (not subprime) loans in any given year.

These financing sources—balance-sheet lending and private-label securitization—both face major challenges going forward.

Balance-sheet lending dominated U.S. mortgage finance in the post-New Deal era as heavily regulated and federally insured banks and thrifts provided most of the home mortgages made to U.S. consumers. But since the 1970s, balance-sheet lending has seen a major decline in importance for at least two reasons. First, the interest-rate shocks of the 1970s and 1980s (which were partially responsible for the savings and loan crisis) made lenders more cautious about taking on too much mortgage risk. This is particularly true for long-dated assets such as the 30-year fixed-rate mortgage, which bear high amounts of interest-rate and liquidity risk.

Second, the federally insured deposits that finance most balance-sheet lending have increasingly declined in importance as U.S. households have shifted more of their wealth to institutional funds (such as pension funds and money market funds). As a result, there is simply less money (on a relative basis) held in banks and thrifts on deposit than there was in the 1950s and 1960s, when banks and thrifts were the primary source of mortgage lending.

Neither of these trends—an aversion to taking on too much rate and liquidity risk or the declining importance of bank and thrift deposits in the larger financial system—appears likely to change anytime soon. As such, it seems highly unlikely that balance-sheet lending will take on a significantly greater role than it already does in the foreseeable future.

It also is difficult to imagine that private-label securitization will reemerge in the foreseeable future as a major source of financing for residential mortgages. There was a brief period in the 2000s when AAA-rated private-label securities—which don't carry a government guarantee—were considered to be equivalent to mortgage-backed securities packaged and sold or guaranteed by Fannie and Freddie. By virtue of the AAA ratings awarded to private-label securities, the investment banks that sponsored these private-label securitizations convinced investors and regulators these securities were safe and liquid, and thus did not require extensive independent due diligence.

As a result, private-label securities were purchased by interest-rate-sensitive investors, allowing private-label securitization to reach an unprecedented 38 percent market share in 2006. Of course, we have since learned that AAA-rated private-label securities were nowhere close to being as safe as government-guaranteed securities. The huge losses suffered by private-label securities, along with the many revelations (which continue to come) of serious structural flaws (such as misaligned servicer incentives and shoddy ratings), have shattered the belief that private-label securities with an AAA credit rating are analogous to securities that enjoy a government guarantee.

As a result, investors remain exceedingly wary. Since the financial crisis, there have been only two private-label securitization deals, amounting to less than $600 million.

This is not to say private-label securitization won't reemerge. It will, although there are still some near-term hurdles to regaining the favor of investors. But going forward, it would seem safe to say that private-label securities, even ones designed to have minimal credit risk, will receive significant amounts of independent due diligence from investors, which in turn will decrease liquidity for these securities.

The need for time-consuming independent due diligence and the relative illiquidity of such securities mean the available pool of capital willing to purchase private-label securities will be much smaller than the pool of capital willing to purchase government-guaranteed securities.[12] So it is difficult to imagine, under these circumstances, that private-label securitization could once again account for 38 percent of mortgage originations as it did in 2006, let alone take on most of the mortgage market, as privatization advocates are proposing.[13]

In summary, the major sources of financing for a privatized mortgage system seem likely to be inadequate to meet the current needs of the $10 trillion-plus U.S. residential mortgage market.

Privatization of the mortgage markets is likely to result in greater instability

Based on the limited historical evidence, it appears likely that privatization would lead to greater instability and more extreme boom-bust cycles. The pre-New Deal mortgage banking system was enormously unstable, experiencing extreme bubble-bust cycles every 5 years to 10 years, with high resulting social costs. During the recent residential mortgage crisis, the purely private portion of the mortgage market—private-label securitization—was the largest driver of mortgage-related losses, accounting for 42 percent of serious delinquencies despite being responsible for only 13 percent of all outstanding mortgages.[14]

And commercial real estate finance, which is essentially privatized, has experienced a bubble-bust cycle even more extreme than that in residential real estate, with a national price decline of more than 40 percent from its peak, greater than the 30 percent price drop experienced in residential real estate.

Privatized mortgage markets are more volatile for at least two reasons. First, private lenders and investors tend to exhibit strong procyclical tendencies—when times are good, they want to make more money and so overleverage themselves, and when times are bad, they want to reduce losses and so excessively pull back on lending. Second, as noted above (and unsurprisingly), private lenders exhibit a strong tendency toward originating lender-friendly mortgages. The highly onerous terms of these loans create a high degree of systemic instability by increasing the likelihood of default and foreclosure.

Of course, the greatest period of mortgage market stability in U.S. history was the post-New Deal era, after high levels of government support were introduced, first in the form of deposit insurance and then in the form of government-guaranteed securitization. Coupled with the "too big to fail" problem, this historical data suggests that a privatized mortgage system would actually pose greater risk to the taxpayer than the status quo.

Arguments using the jumbo market as evidence are flawed

Some have pointed to the availability of competitively priced 30-year fixed-rate mortgages in the jumbo market, which serves borrowers seeking high-balance loans that fall above the loan limits of Fannie Mae and Freddie Mac, as evidence that private capital can serve the needs of the broader mortgage market.

This argument is flawed. The jumbo market serves higher-income, higher-wealth borrowers, and no one disputes that the private markets can serve this market well—just as they have always done. In fact, our current system explicitly assumes that wealthy Americans will be served without a government guarantee, which is why there are loan limits for Fannie and Freddie.

But as discussed above, there are serious questions about the ability of the private markets to provide sufficient liquidity to the broader U.S. mortgage market. The sources of capital that currently finance jumbo loans face significant barriers to scalability and it is difficult to imagine that balance-sheet lending or private-label securitization can finance the $5.5 trillion in mortgage originations currently held by Fannie and Freddie in the absence of a government guarantee.

Moreover, the jumbo-mortgage argument ignores the inherent tendency of purely private lenders toward products that are more onerous for borrowers. This includes not only the horrific experience of private-label securitization in the 2000s but also the jumbo market more generally. From 1990 to 2007, the jumbo markets originated more adjustable-rate loans than fixed-rate loans nearly every year. This was in stark contrast to the conforming market, which originated more fixed-rate loans than adjustable-rate loans every single year.[15]

Even to the extent that long-term, fixed-rate mortgages have been offered in the jumbo market, these have been integrally tied to the government-supported segment of the market. First, Fannie and Freddie have set a market standard, providing 30-year fixed-rate loans at affordable prices. Obviously, their private competitors must provide products on terms and prices that are competitive with that benchmark.

Second, lenders were able to significantly lower their cost of funding jumbo 30-year fixed-rate mortgages through the market infrastructure that existed around Fannie and Freddie securities. Prior to the financial crisis, jumbo mortgages were frequently hedged through transactions in the so-called "To Be Announced," or TBA market, the very deep and liquid forward market for trading securities issued by Fannie and Freddie (which allows consumers to lock in their mortgage rates, among other things).[16]

In other words, Fannie and Freddie not only provide enormous market pressure on private lenders to offer competitively priced jumbo 30-year fixed-rate loans but they also provide the market infrastructure that allows jumbo lenders to offer lower pricing on this product. If we privatized the market served by Fannie and Freddie, we would be removing both the incentive *and* much of the ability to offer affordable 30-year fixed-rate loans. It is difficult to imagine that the 30-year fixed-rate mortgage would continue to be offered broadly under these circumstances.

Conclusion

As the debate over mortgage finance reform becomes fully engaged on Capitol Hill, it is imperative that both the Obama administration and Congress consider how to preserve the benefits of the system that Americans rightly value while making the system safer and more protected against the kind of bubble-bust cycle that led to the Great Recession of 2007-2009. There are many criticisms of the current home mortgage finance system that are appropriately being explored but our political leaders must also be careful not to throw the baby out with the bathwater.

Many parts of the U.S. mortgage system that policymakers have long placed high value upon, in particular the broad availability of good, sustainable mortgage products such as the 30-year fixed-rate loan, are integrally tied to the government support that has long been the mainstay of the modern U.S. mortgage system. That's why policymakers must very carefully consider the consequences of privatizing the mortgage markets, many of which are incompatible with core American values.

Americans place value on the idea that middle-class and working-class households should have access to homeownership, or in the alternative, affordable rental options. Privatization of the home mortgage market is inconsistent with this idea. Americans also value small banks and thrifts, and disfavor the domination of banks that are "too big to fail." Privatization is incompatible with this ethos. Americans place value on the availability of consumer-friendly mortgage products such as the 30-year fixed-rate mortgage, yet privatization would of course eliminate this product and tilt the scale towards products that are risky for consumers and more profitable for banks.

Endnotes

1 Priyank Gandhi and Hanno Lustig, "Size Anomalies in US Bank Stock Returns: Your Tax Dollars at Work?" (Los Angeles: UCLA Anderson School of Management, 2010).

2 Ibid.

3 Jaret Seiberg, "Housing Finance: Fannie and Freddie Ain't Dead Yet," MF Global Financial Services Bulletin, February 11, 2011.

4 Moreover, as Moody's Chief Economist Mark Zandi points out, a privatized system would result in a more fractured, less liquid market, leading to more profitable arbitrage opportunities for Wall Street firms. Cristian deRitis and Mark Zandi, "Responding to Critics of a Hybrid Mortgage System," Dismal Scientist, February 17, 2011, available at http://www.economy.com/dismal/article_free.asp?cid=197265&src=mark-zandi.

5 Some commentators argue that Europe provides a model for privatized mortgage markets, noting the lack of explicit government guarantees in European economies. This claim is misleading because it ignores the dominant role of implicit government guarantees provided by European governments, similar to the ones provided by the U.S. government to Fannie Mae and Freddie Mac. European countries have always bailed out their mortgage banks, and this implied guarantee is explicitly factored into the credit ratings of European financial institutions (and their debt obligations) by the major credit rating agencies. In effect, European governments provide a 100 percent guarantee of their mortgage markets, as most recently evidenced by the sweeping bailouts (including bank nationalizations and blanket guarantees) in Germany, Denmark, Italy, the United Kingdom, and Ireland. As one European Central Bank official has reportedly said, "We don't let banks fail. We don't even let dry cleaners fail," as quoted in: David Wessel, "In Fed We Trust: Ben Bernanke's War on the Great Panic" (New York: Crown Publishing Group, 2009)

6 See, for example: Richard Green and Susan M. Wachter, "The American Mortgage in Historical and International Context," *Journal of Economic Perspectives* 19 (4) (2005): 93–114, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=908976.

7 While there is no direct government support for commercial mortgage financing, there is some indirect government support for the sector. Affordable multifamily buildings are financed in part by direct investments made by Fannie Mae and Freddie Mac (subsidized by a lower cost of debt made possible by a government guarantee). Commercial real estate debt is also financed to a large degree (slightly less than half of all outstanding loans) by banks, which benefit from federally insured deposit insurance. That being said, the level of government support in commercial mortgage financing is generally consistent with the level of government support described in the proposals for privatizing the residential mortgage market (which retain Federal Housing Administraton and Veterans Administration lending and federal deposit insurance for banks and thrifts), so we think the comparison is highly apt.

8 Federal Housing Finance Agency, "Data on the Risk Characteristics and Performance of Single-Family Mortgages Originated from 2001 through 2008 and Financed in the Secondary Market" (2010), available at http://www.fhfa.gov/webfiles/16711/RiskChars9132010.pdf.

9 Fannie Mae and Freddie Mac purchase and pool mortgages, and issue securities based on the mortgage payments from the pool. Fannie and Freddie guarantee timely payment of principal and interest on these securities, should the underlying mortgage payments be insufficient (for example, because of a higher-than-expected number of loan defaults), and the government was understood to stand behind Fannie and Freddie. Ginnie Mae does not pool and securitize mortgages but rather guarantees the timely payment of principal and interest for mortgage-backed securities, issued by approved private parties and made up of loans insured by the Federal Housing Administration and other government agencies.

10 During the 2000s housing bubble, investors and regulators became convinced that nonguaranteed securities could meet these same investment criteria, so long as they were rated AA or AAA by an independent credit rating agency. Obviously, the high loss rates on these securities, resulting in enormous losses throughout the financial system, illustrated the magnitude of this error.

11 Most balance-sheet lending is still backed by the federal government through federally guaranteed deposit insurance provided to regulated banks, thrifts, and certain other lenders.

12 A recent Fitch Ratings report makes a similar point, noting that historically, interest-rate-sensitive investors provided the bulk of U.S. mortgage financing through their purchases of government agency securities, while credit-risk-sensitive investors have purchased private-label securities. Joo-Yung Lee and Robert Grossman, "U.S. Housing Reform Proposal FAQs: Filling the Void" (New York: Fitch Ratings, 2011).

13 Some policymakers have argued for the creation of a robust U.S. market for covered bonds, based on the relative success of this financing instrument in Europe. Covered bonds are a sort of hybrid instrument, combining some elements of mortgage-backed securities and some elements of corporate senior debt. As I will argue in an upcoming paper, covered bonds are not an appropriate fit for the United States for a number of reasons, including that they encourage (and are integrally connected with) "too big to fail," that they are redundant to FDIC depository insurance, and significantly increase the risk of taxpayer loss.

14 James B. Lockhart, "FHFA's First Anniversary and Challenges Ahead," Speech before the National Press Club, July 30, 2009.

15 Forrest Pafenberg, "Single-Family Mortgages Originated and Outstanding: 1990-2004," (Washington: Office of Federal Housing Enterprise Oversight, 2005), table 2, available at http://www.fhfa.gov/webfiles/1151/mortmarket1990to2004.pdf; Federal Housing Finance Agency, "Updated Assumptions Used to Estimate Single-Family Mortgages Originated and Outstanding, 1990-2009" (2010), table 2, available at http://www.fhfa.gov/webfiles/15722/Updated_assumptions_2009_050510.pdf.

16 Following the financial crisis, it is less clear that such hedging will be as prevalent, given the sharp differences in liquidity that were illustrated between jumbos and conforming loans.

About the author

David Min is Associate Director for Financial Markets Policy at the Center for American Progress. He leads the activities of the Mortgage Finance Working Group, a group of leading experts, academics, and progressive stakeholders in housing finance first assembled by the Center for American Progress in 2008 to better understand the causes of the mortgage crisis and create a framework for the future of the U.S. mortgage system. David also works on financial market issues for the Center.

Prior to joining the Center, he was a senior policy advisor and counsel with the Joint Economic Committee of the U.S. Congress, where he focused on policy solutions to the credit crisis, as well as other macroeconomic and financial markets issues. David was formerly the Banking Committee counsel for Sen. Charles Schumer (D-NY). Before coming to Capitol Hill, David was a securities litigator, first as an Enforcement Division attorney at the Securities and Exchange Commission, and later in the Washington, D.C. office of WilmerHale LLP.

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