

We Need Fundamental Mortgage Reform

By BERT ELY

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Yesterday's federal takeover of Fannie Mae and Freddie Mac was necessary and should help in the short term to stabilize U.S. home-mortgage lending.

But this event must spark fundamental rethinking about how best to finance American home mortgages. As we've seen numerous times in recent years, narrowly based or "monoline" financial entities fail when problems arise in their particular line of business.

Municipal bond insurers exemplify the failure of that business model. Mortgage insurers have experienced difficulty, too, while the monoline credit-card issuers have been acquired or diversified. Banks that have failed recently were too heavily concentrated in construction lending. S&Ls in the early 1980s were too heavily concentrated in home lending. Arguably, Bear Stearns was too narrowly focused on an institutional customer base.

Two characteristics are key to safe, efficient, fixed-rate mortgage lending: the lender's retention of credit risk and maturity-matched funding, i.e., funding fixed-rate mortgages with debt of comparable maturities. To a great extent, those characteristics have been missing in home-mortgage lending. Instead, lenders often have passed mortgage credit risk to others through the securitization process. Securitization also incurs high transaction costs, particularly when home mortgages are merely refinanced at a lower interest rate.

Maturity mismatching (funding long-term assets with short-term debt), the initial cause of the S&L crisis in the early 1980s, has continued to today, notably at Fannie and Freddie. While they tried to hedge that mismatching through derivatives, their recent problems stem in part from difficulties in rolling over their short-term debt.

We need rule changes to help diversified lenders to safely make and hold on-balance-sheet, long-term, fixed-rate home mortgages alongside a broad range of other types of loans and investments.

Regulatory impediments must be removed to permit the growth of "covered bond" financing for home mortgages. Covered bonds are on-balance-sheet borrowings secured by mortgages owned by the issuer of the bonds.

For example, a bank might issue \$2 billion of covered bonds with five-year and 10-year maturities that are secured at all times by at least \$2.1 billion of performing home mortgages. Because of that security, covered bonds are highly rated, usually AAA.

Covered bonds have been issued in Europe for over two centuries; approximately \$3 trillion of these bonds are outstanding today. They are a well-tested innovation, yet only two U.S. lenders have issued them: Bank of America and Washington Mutual.

By issuing long-term covered bonds, a mortgage lender can safely hold on its balance sheet the fixed-rate mortgages it has made. This gives the lender a powerful incentive to make good lending decisions because it will be stuck with its lending errors.

Treasury Secretary Henry Paulson has strongly endorsed covered-bond financing. On July 28, Treasury issued a set of "best practices" for covered-bond issuance. Unfortunately, those best practices have been unnecessarily constrained by an excessively narrow and parochial Covered Bond Policy Statement from the Federal Deposit Insurance Corporation.

Rep. Scott Garrett (R., N.J.) has introduced legislation to provide important statutory protections for covered-bond investors, along the lines of European protections.

Investors need to gain comfort with covered bonds and a secondary market for them will take time to develop. But they have the potential to fund a significant portion of the \$10 trillion outstanding today in home mortgages. No longer would lenders feel compelled to sell the fixed-rate mortgages they make into a secondary mortgage market dominated by Fannie and Freddie. Instead, they could safely keep those mortgages.

Funding mortgages with covered bonds also will permit banks and other lenders to experiment with mortgage innovations that are difficult to implement today because of how the secondary market deals with refinances. Even though the essence of a mortgage refinance is simply to reduce the mortgage interest rate, that can be accomplished today only by paying off the old mortgage and replacing it with a new mortgage that has to be sold and then securitized. That is expensive, as anyone who has refinanced knows.

If banks used covered bonds to fund and keep the fixed-rate mortgages they originated, they could experiment with ways to lower the rate on those mortgages without incurring all the transaction costs now triggered by a mortgage refinance. Such innovations could save homeowners billions of dollars annually when reducing the interest rate on their mortgages.

Covered bonds and mortgage innovations are not the entire answer to improving the safety and efficiency of the U.S. mortgage marketplace. However, they are representative of the types of innovations which are needed to move the United States away from a mortgage-finance infrastructure which is both inefficient and extremely risky to taxpayers, as the government takeover of Fannie and Freddie has demonstrated.

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