

Introduction

Conference on the Danish Mortgage System

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Peter J. Wallison

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Although members of Congress and the Obama administration have sweeping ideas for how to regulate the U.S. economy in the future, few of them have apparently thought very deeply about how we finance mortgages. Yet, at the root of the country's current financial crisis is a dysfunctional mortgage system.

The central actors in that system are two bankrupt companies—Fannie Mae and Freddie Mac—that are likely to cost taxpayers \$400 billion by the time all their losses are toted up and their conservatorship brought to an end. Their lack of adequate regulation and domination of housing finance were, more than any other factor, responsible for the financial crisis we now confront.

In light of this, one would think that rather than planning to extend regulation to the farthest reaches of the financial system—regulation, incidentally, that has not worked very well in preventing bank weakness and failure—policy makers would spend a little time thinking about how to reform a mortgage financing system that has obvious and major deficiencies.

But in listening to Barney Frank and others, the most serious thinking they have done is to require all participants in the securitization process to have some skin in the game by taking a piece of the risk associated with a securitized mortgage. This is a perfectly reasonable idea, but it raises all kinds of thorny technical issues and is not remotely as substantial a change as they are promoting in the regulation of the financial system as a whole.

To its credit, the Bush administration—as one of its last policy efforts in the financial area—published an interesting and favorable report on how a covered bond system might work in the United States. We had a conference on this issue in September, at which Alex Pollock and Bert Ely, two of our panelists today, were discussants.

Suffice it to say that there were plenty of questions about the Treasury and FDIC plan that had to be answered before the covered bond idea could be considered workable. But at least someone was thinking. In any event, we've heard no more about it in the six months since the conference, and given the fact that Treasury is now woefully understaffed, and the FDIC is fully engaged in the current problems of the banking industry, it will be a while—if ever—before anyone at either agency turns his or her attention to considering the implementation of a covered bond program.

One of the useful things that we try to do here at AEI is look a little bit ahead of the day-to-day controversies that usually absorb Washington to consider policy issues that need attention. And a restructuring of the housing finance system certainly qualifies on that score.

That's why we're having this conference today, despite the fact that everyone's attention in Washington is on the sexier question of who will regulate whom, and how much.

I have long been intrigued by the Danish mortgage system. This is the second or third conference in which it has been discussed, but it's the first one at AEI where the Danish system is the focus of attention. It is attractive because it does not involve any explicit or implicit taxpayer liability; permits homeowners to take advantage of declines in the housing values—a particular advantage in the U.S. market today; and appropriately separates interest rate and credit risk. If these advantages can be retained in the immensely larger U.S. housing finance market, that would be a substantial advance indeed over where we are today.

When Alan Boyce—an expert in the Danish system—volunteered to describe how the Danish system might be grafted onto the U.S. securitization system, it was an irresistible opportunity to see to what extent the advantages of the Danish system might be obtainable in the United States.

As you will see, Alan's plan does not do away entirely with government involvement and liability, but he outlines how other advantages of the Danish system might be available in a restructured U.S. mortgage market.