Senator Elizabeth Warren
Speech before the Mortgage Bankers Association
Washington, DC

As Prepared for Delivery
October 29, 2013

Thank you Deb for that kind introduction, and thank you David for inviting me to speak at your 100th annual convention. I'm particularly happy to be here to talk about an issue that Congress has been working on and that I know is on many of your minds: housing finance reform.

Thanks in part to the companies represented in this room, home ownership remains the centerpiece of the American Dream. Across the world, home ownership is too often reserved for the well-off. But in America, thanks to lower down payment requirements and the prevalence of the 30-year fixed mortgage, home ownership is widely accessible. Widespread access to home ownership allows lower- and middle-income families to build savings, and it produces the stable communities that are the backbone of this country.

As we move forward in the debate over housing finance reform, it's critical that we fight to maintain the unique character of the American housing market. Don't get me wrong: I think reform is absolutely necessary. Fannie and Freddie cannot remain in conservatorship indefinitely, and taxpayers should not bear the risk of nearly all of the $10 trillion housing market. But we also must act carefully. If we get housing finance wrong, the impact will be felt throughout America's middle class. No politics here – we just need to focus on getting housing finance right.

Perhaps the first step in designing a new housing finance system is understanding what went wrong with the old system. If we're clear on that, we can steer clear of the same mistakes.

While the crisis was massive and painful – and its impact continues to weigh on middle-class families to this day – its underlying cause was fairly clear. According to the Financial Crisis Inquiry Commission, the crisis was triggered by the rapid growth in the origination and securitization of subprime loans in the private-label market. There were other contributing factors, of course, but fundamentally, the crisis started one lousy mortgage at a time.

The GSEs made significant mistakes – mistakes that cost taxpayers dearly – but those mistakes were *not* the underlying cause of the crisis. We now have some good, independent research on this from the Federal Reserve Bank of St. Louis. Their careful analysis shows that despite claims to the contrary, Fannie and Freddie's affordable housing goals were not to blame, not even a little bit, for the rapid increase in subprime originations. Although Fannie and Freddie purchased securities backed by subprime loans, and some of those purchases helped fulfill their affordable housing goals, the St. Louis Fed economists found that the housing goals had no impact – *no impact* – on either the number of subprime loans originated or the price of those loans in the private-label market.[1] Affordable housing goals have been scapegoated by those who have been itching to get rid of the goals for a long time, but I think it's time to drop that red herring.

In fact, the data are pretty clear about what went wrong: Fannie and Freddie's mistakes resulted from their attempt to increase profits for their private shareholders. As they saw private-market participants making money hand-over-fist, the GSEs dramatically increased their leverage and purchased billions in supposedly low-risk, private-label, mortgage-backed securities. At the same time, they sought to generate more fees by lowering their underwriting standards and purchasing Alt-A loans – loans to borrowers who were categorized as prime but were not required to provide any income documentation. When housing prices stagnated and borrowers started missing payments, Fannie and Freddie didn't have the capital to absorb the losses.

I think the history here provides a valuable lesson. At its core, the story of the housing crisis is a story of moral hazard for all three players – originators, private-label issuers in the secondary market, and Fannie and Freddie. In the private-label market, originators had too little incentive to assess whether subprime borrowers could repay their loans because often they immediately sold those mortgages into the secondary market where they became someone else's problem. And for their part, private-label issuers had too little incentive to verify the quality of the loans they purchased because they could pool them together and slice them up to obtain favorable credit ratings even for the riskiest tranches – pretending those problem loans had disappeared. As for Fannie and Freddie, they had too little incentive to manage their risk because they would reap the profits if things went well, and everyone knew the government would step in to bail them out if things went poorly.

So how should we address moral hazard while preserving the good aspects of the pre-crisis housing finance system? That is the key question. There is no silver bullet, but here are some ideas.

First, I think it's critical to replace the implicit guarantee for Fannie and Freddie that existed leading up to the crisis with an explicit, privately financed guarantee for whatever entity or entities replace Fannie and Freddie. The guarantee should be expressly limited and conditioned on private capital occupying a significant first-loss position, but it must be there. We have to be realistic: the housing market is so large, and so important to ordinary Americans, that there is no plausible scenario in which the government does not guarantee at least a portion of it. There will always be a government guarantee, and, in my view, an explicit guarantee is vastly superior to an implicit one. An explicit guarantee is like any other insurance policy – customers pay for the insurance and it can be expressly limited. And an explicit guarantee will provide the assurance the market needs to make 30-year fixed mortgages broadly available.

---

[1] Ruben Hernandez-Murillo, Andra C. Ghent, and Michael T. Owyang, Federal Reserve Bank of St. Louis, *Did Affordable Housing Goals Contribute to the Subprime Securities Boom?* (Aug. 2012), *at* http://research.stlouisfed.org/wp/2012/2012-005.pdf.

Second, to address the moral hazard in the private-label market, we need to adequately regulate market participants. As the data show, the private-label market sparked the crisis, and focusing only on the government-insured portion of the market won't produce the long-term stability both the housing market and the economy require. Most originators will sell most of their loans into the secondary market, and the liquidity that generates is a good thing because it helps provide more financing for more borrowers. But it is essential that originators have adequate incentives to assess the ability of borrowers to repay their loans. The QM and the proposed QRM rules are a critically important start. They create an incentive for lenders to write quality loans and thereby reduce the amount of high-risk debt. Those rules are not absolute restrictions, however, and when the market heats up again, lenders are likely to once again write non-QM loans. The potential liability associated with writing non-QM loans is relatively small, and in good times, lenders can compensate for those possible losses with higher rates or fees. And so, in my view, we need to consider strengthening or supplementing the QM rule so that it provides an adequate check on overly risky lending even during housing booms.

Third, we should solve the servicer and trustee problems that emerged during the crisis and its aftermath. Servicers were supposed to act in the best interest of investors, but because of certain financial incentives, such as holding second liens on mortgages they serviced or receiving larger fees for foreclosures than for loan modifications, many servicers failed to pursue loan modifications that would have benefitted both homeowners and investors. Because they owed no formal fiduciary duty to investors, the trustees were often lax in supervising the servicers. Aligning the interests of servicers, trustees, and investors in both the guaranteed and the private-label markets is critical because it will have an impact on the size and depth of any housing downturn. Increasing beneficial loan modifications and reducing unnecessary foreclosures can be the difference between a short, mild downturn and a lengthy, nationwide crisis. We learned that one the hard way.

Fourth, we must make sure that the new system doesn't exacerbate the Too Big to Fail problem by increasing the competitive advantages the largest financial institutions have over everyone else. The primary market is already dominated by a handful of large players. It would be easy to create a system that allows those large players to translate their primary market dominance into dominance in the secondary market, which in turn would increase their competitive advantages in the primary market. We must not end up with a housing market that crowds out smaller financial institutions. A housing market dominated by a handful of Too Big to Fail institutions would reduce access to mortgages in rural and poorer urban areas. It would also increase systemic risk and reduce innovation and customization in the primary market. Any future housing finance system must ensure not only that smaller lenders can sell their loans into the secondary market, but also that they can do so at competitive rates and remain viable players in the primary market.

Fifth, we need to make sure that the portion of the secondary market that is government-guaranteed serves the *entire* primary market. Left to its own devices, the secondary market may not produce adequate demand for loans to borrowers in certain parts of the country, or for smaller loans to lower-income borrowers. Because 70% of loans are sold into the secondary market, if that market isn't interested in certain kinds of loans, then originators will be less likely to write those loans in the first place. The American housing market should not have those kinds of gaps. Either collectively or individually, issuers of mortgage-backed securities that are government-guaranteed should have a clear and enforceable duty to serve the entire primary market.

I'm glad to see that there is momentum behind housing finance reform right now. Senators Corker and Warner, in particular, have done a remarkable job moving the debate forward in the Senate with the bill they've introduced. I don't think it's a perfect bill, but I applaud them and their co-sponsors for the work they've put into this. I'm also glad Chairman Johnson and Senator Crapo are holding hearings and working on this issue as well. Housing finance reform is a complex puzzle, and it will take a lot of work from a lot of people to make sure the pieces fit correctly.

The $10 trillion housing market affects every American, and its current form is unsustainable. We need reform, but it must be targeted reform that seeks to preserve the good things about the old, pre-crisis system. America has been a more prosperous and more socially mobile society because of the benefits of widespread home ownership. If we keep that in mind as we consider housing finance reform, and if we approach the task with seriousness and a hard look at the data and the facts, I believe we can temper the boom-bust cycle while maintaining the qualities that set the American housing market apart from the rest of the world.

This is an issue I look forward to working on with the MBA and its members, and I very much appreciate the opportunity to speak with you today. Thank you.

###