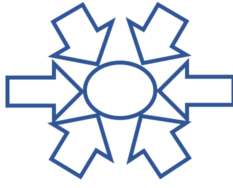

GSE Activity Report

Monday, January 22, 2024

Securitization and Systemic Risk

A new Fed staff study uses models to conclude that government-backed mortgage securitization exacerbates financial crises, contradicting conventional wisdom that – GSE blow-ups notwithstanding – properly-regulated GSEs create a liquid, diversified asset pool for an otherwise illiquid, risky asset class. However, our read of the study leads us to side with conventional wisdom.

This paper is by the Fed's long-time GSE expert, Wayne Passmore, along with Roger Sparks. The paper bases its conclusion on models finding that banks adversely-select GSE-underwriting models. This may well be true, but the majority of GSE-bound loans now come from nonbanks with no portfolio capacity or a more profitable, liquid PLS-market option to take what they keep. The paper also assumes the Home Loan Banks create MBS. Much as they would like to do so, they don't. A less significant, but notable, technical problem with the study is that it assumes that borrowers always borrow the full house price. This is of course prohibited for Fannie and Freddie without MI and not even true for FHA (strangely omitted from the analysis).

We also question the extent to which banks would actually hold a 100% LTV as assumed by the study regardless of its other credit-risk benefits because the capital cost of a 100% LTV is so much higher. Thus, where the GSEs buy high-LTV loans, banks will almost surely sell them if the loan value fits GSE criteria. Where the high-LTV loan can't go to the GSEs or FHA, the bank is unlikely to book it. The model also assumes that wealthy investors prefer bank equity to Treasury securities, with the only option a bank has if it doesn't make a mortgage holding depositor funds in USG obligations.

Based in part on its finding that GSEs amplify crisis risk, the paper goes on to posit that government subsidies designed to enhance mortgage availability are best directed at originators, not securitizers. It suggests that these come by way of reducing foreclosure costs – i.e., loss severity. Again, this seems a models-driven solution that overlooks real-world problems such as the fact that banks generally carry mortgages under the standardized approach – perhaps soon to be the norm – based on LTV regardless of loss severity unless and until regulators revise the risk-based capital rules. This happens about once a decade and, as current evidence suggests, is not exactly easy.

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