from encouraging the extension of risky loans that put households in financial jeopardy and seed systemic risks.

In the mid-2000's, private-label mortgage backed securities grew to surpass Fannie Mae and Freddie Mac's market share, as the GSEs new business as a share fell from 57% in 2003 to just 37% in 2005 and 2006.[xvii] Eventually, Fannie Mae and Freddie Mac increased purchases of non-traditional loans, which generated substantial losses. For example, Alt-A loans represented just 7% of Fannie Mae mortgages from 2004 and earlier, but increased to about 20% in 2005 and 2006.

Such purchases were not driven by policy concerns. Alt-A mortgages are generally characterized as loans to borrowers with good credit but using nontraditional underwriting standards. For example, Alt-A loans often use no or limited documents of income and assets. A Federal Reserve review states that 50% to 60% of Alt-A loans generally involves low documentation, but that share increased to 78% by the end of 2006.[xviii] Loans without income documentation, particularly if used as a way to inflate income, are less likely to be claimed to be to lower income borrowers. In fact, according to the GSE's second quarter 2008 credit supplements, the average loan amount for an Alt-A loan purchased by the GSEs was above $170,000 and only a small share – 5% - of these loans had LTV above 90%. Further, the average FICO score on Alt-A mortgages was a reasonably strong 715 for Fannie Mae and 724 for Freddie Mac.

There are also reasons to believe Alt-A loans are not targeted toward underserved neighborhoods. Using the average outstanding balance and mark-to-market LTV, the average value of property behind a Fannie Mae Alt-A loan was over $250,000 in 2007, substantially greater than other "non-traditional" loan categories and over 15% greater than the median sales price for all existing single-family homes that year. These Alt-A loans led to substantial losses. In the first half of 2008 (the half preceding conservatorship), Alt-A loans accounted for nearly 11% of Fannie Mae's single-family book of business, but accounted for over between 43 and 49% of their credit losses.

Meanwhile, data from FHFA shows Fannie and Freddie purchased roughly 9.5 million loans between 2005 and 2007 that qualified for one or more affordable housing goals. Nearly 73% of these had loan-to-value ratios of 80% or less. Less than 17% had LTV ratios over 90%.[xix] Applying the reported ever 90-day delinquency rate of all GSE loans by LTV categories, the estimated default rate of loans purchased in this time period by Fannie and Freddie with this distribution of LTV ratios is barely above their overall default rate for all loans purchased over the period. Even if we conservatively apply the default rate for loans under 660 within each LTV bucket, this increases the roughly estimated default rate for these loans to a leve substantially below the comparable default rate for all loans financed by private-label securities, regardless of LTV or FICO. Further, in comparisons of rates of serious delinquency between the GSEs and the private label market in all categories of LTV and credit score for loans originated and acquired from 2001 through 2007, GSE loans outperform private label MBS loans, usually by huge margins. [xx]

Taken together with our research findings on a large portfolio of loans originated under Community Reinvestment Act and Affordable Housing programs, these results support the conclusion that the use of prime-market-rate, fixed-rate mortgages for lending to low- and moderate-income borrowers lead to lower defaults than non-traditional loans by private origination channels.

Transparency and Accountability are just part of the solution

Clearly, rebuilding the US financial system is no easy task, but learning from the past – both what worked well and what failed - offers the opportunity to establish a more stable system than ever before. Accountability and transparency are two critical elements, and coupled with consumer protection measures of Dodd-Frank, comprise part of the overall solution. But alone, they will not replenish the flow of capital needed to support a robust housing market over the long term and through business cycles. In fact, even as the pure private market gradually returns, a sole reliance on pure private markets will put the

housing market recovery at risk in the short term. In the long-term, it will leave some markets in some economic cycles cut off from a liquid supply of mortgage credit on fair and sustainable terms and the entire economy exposed to bubble-bust cycles. To return to long-term vibrancy and resilience, the system must also provide for liquidity on a broad and constant basis; stability; and access to affordable financing for homeownership and rental.

Broad and constant liquidity to fund the $11 trillion US mortgage market
A substantial share of the market can be served mostly by private capital with the provision of a limited federal backstop that is highly protected by adequate private capital in the first loss position, and that is explicit and paid for. Such a mechanism will provide investors the confidence to deliver a reliable supply of capital for both rental and homeownership options, every day and in every community, during all kinds of different economic conditions, through large and small lenders alike.

Financial stability instead of volatility
As we have been reminded, when left to its own devices, the mortgage market is inherently inclined toward extreme bubble-bust cycles, which cause significant wealth destruction that brings with it devastating repercussions not only for homeowners and lenders but also for neighborhood stability, the financial system, and the broader economy. Mitigating that tendency requires strong, consistently enforced underwriting standards and capital requirements that are applied equally across all mortgage financing channels for the long cycle of mortgage risk, and mechanisms that assure countercyclical funding availability.

Affordable and sustainable financing for both homeownership and rental housing
Liquidity and stability are essential to affordability and, for most families, the lower housing costs produced by the modern mortgage finance system over the past half century (before the recent crises) enabled them to build equity, save, and invest.

A pillar of this housing system is affordably priced long-term, fixed-rate, fully self-amortizing, prepayable mortgages. The long term provides borrowers with an affordable payment while the fixed-rate, the option to prepay, and self-amortization features provide the financial stability and forced savings that are critically important to most families, while retaining the opportunity for mobility.
Multifamily rental housing also gains stability from long-term, fixed-rate financing as it results in more affordable and stable rents.

In the absence of government policies designed to explicitly support long-term, fixed-rate mortgages, it is likely that this type of mortgage would largely disappear from the U.S. housing landscape or become unaffordable to the nation's middle class, which has been so effectively served by 30-year residential mortgages, and to the nation's many renters who rely on multifamily property owners' ability to finance and refinance their apartment buildings.

Liquidity, stability and the efficiently priced long-term fixed rate mortgage contributed to the building of a strong middle class and has been an important guiding concept in modern U.S. housing finance policy—and a key component of the American socioeconomic mobility of the 20th century. It has not always been available to all qualified borrowers, however.

Broad access to such sustainable financing for all qualified homeowners and renters can be achieved in the future -- if successors to certain GSE functions are structured to be able to make non-QRM mortgages. With adequate capitalization, standardization and oversight, GSE successors should facilitate certain non-QRM mortgages in a way that protects taxpayers while adding stability to the housing market.

In conclusion, restoring investor confidence in the mortgage market will require much greater transparency than in the past. It will also require more accountability on the part of agents, as envisioned by the Dodd-Frank Act's risk-retention provisions. However, regulators should proceed with care to avoid putting an unintended and pro-cyclical damper on the fragile finance system. In particular, our research suggests that a broad QRM definition will better balance the value of risk-retention with the goal of reducing the government role in the market from current levels and protecting the taxpayer over the long run. Our research suggests that it is more appropriate to apply risk retention requirements to mortgages with features that in and of themselves increase risk, rather than to borrower characteristics. Finally, the ultimate impact of these measures is highly dependent on the form that the mortgage secondary market takes. As you move forward in this complex reform process, it is important to bring private capital back and protect the taxpayer, but it is also important restore the financial system so that it works better for the American households who rely on it for their economic security. You cannot have true transparency and valuable information at any level if, at the origination level, the risks are not understood by the borrower.

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[i] Levitan, Adam and Susan Wachter, 2010. Information Failure and the US Mortgage Crisis. University of Pennsylvania Law School Institute for Law and Economics.

[ii] The TBA or To Be Announced Market allows conforming, conventional mortgages to trade more efficiently and allows borrowers to lock rates in advance of closing. For an excellent description, please see James Vickery and Joshua Wright, 2010, TBA Trading and Liquidity in the Agency MBS Market. Federal Reserve Bank of New York Staff Report no. 468.

[iii] http://www.americansecuritization.com/uploadedFiles/ASF_Project_RESTART_Final_Release_7_15_09.pdf

[iv] See http://www.americansecuritization.com/story.aspx?id=3461.

[v] Amherst Mortgage Insight, May 20, 2010. Lori Goodman, Roger Ashworth, Brian Landy and Lidan Yang. The Elephant in the Room--Conflicts of Interest in Residential Mortgage Securitizations. Amherst Securities Group LP.

[vi] SEC (2008). Summary report of issues identified in the commission staff's examinations of select credit rating agencies. July 8 2008, United States Securities and Exchange Commission. http://www.sec.gov/news/studies/2008/craexamination070808.pdf.

[vii] Donnelly, Catherine and Paul Embrechts, 2010. The Devil is in the Tails: Actuarial Mathematics and the Subprime Mortgage Crisis. RiskLab, ETH Zurich, Switzerland.

[viii] See for example Statement of Edward J. DeMarco before the US House of Representatives Subcommittee on Capital Markets, Insurance and Government Sponsored Entities, March 31, 2011 regarding Credit Quality (p. 2) and Written Testimony of David H. Stevens, "FHA Capital Reserve Ratio," before the Subcommittee on Housing and Community Opportunity, US House Committee on Financial Services, October 8, 2009.

[ix] Interagency Notice of Proposed Rule Making on Credit Risk Retention. March 28, 2011.

[x] Abromowitz, David and Janneke Ratcliffe, April 1, 2010. Homeownership Done Right-What Experience and Research Teaches Us, Center for American Progress. Available via http://www.americanprogress.org/issues/2010/04/homeownership_right.html

[xi] Ding, Lei, Roberto Quercia, Wei Li and Janneke Ratcliffe, 2010. Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models. http://www.ccc.unc.edu/abstracts/091308_Risky.php

[xii] Board of Governors of the Federal Reserve, Balance Sheet of Households and Nonprofit Organizations (2010) available at http://www.federalreserve.gov/releases/z1/Current/z1r-5.pdf

[xiii] Di, Zhu Xiaou Housing Wealth and Household Net Wealth in the United States: A New Profile Based on the Recently Released 2001 SCF Data (Cambridge: Joint Center for Housing Studies, Harvard University, 2003).

[xiv] Thomas M. Shapiro, Tatjana Meschede, and Laura Sullivan, The Racial Wealth Gap Increases Fourfold. (Waltham: Institute on Assets and Social Policy, 2010).

[xv] Joint Center for Housing Studies, Harvard University, State of the Nation's Housing 2009; Appendix W-5 (2009).

[xvi] U.S. Census Bureau 2010 Statistical Abstract. 35.5 percent of U.S. households earned less than $35,000 (2007 dollars).