

Localizing homeowner credit risk decisions and management - why new SSEs (State Sponsored Enterprises) may be better replacements for the current GSEs in a new national housing finance system

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Undoubtedly, our country's current housing finance system is broken. We have an urgent need for a replacement system. The federal government seems to be running out of tricks up its sleeves to cope with the problems. To get local governments' active involvement in a new housing finance system may seem to be a novel idea to many people and it could indeed be a daunting task. In reality, they should have as much incentive to devote their energy to community development than they normally do in their economic development efforts on the business side. They will need plenty of stable long term residents to take those jobs created by the new business they are trying to bring in. However most of these community development efforts have been done by using tax payers money in the past. More free market oriented housing finance alternatives could be a worthwhile direction to look into. In foreign countries such as the UK, the active involvement of the local governments in the housing issues is more a norm than an exception.

The hands-off approach by the local governments in the US in the past to allow the unregulated and unscrupulous private sector financial institutions to come in to the local communities, make a mess, take the profit and leave had contributed to our current mortgage mess in many states, counties and cities. The property value and utility taxes are the lifeline that the local government's finances rely on. The state, county and city governments will have to realize that it is their job to fix these problems now before the problems deteriorate further. Leaving it to the federal government does not seem to be a viable option any more.

The government's role in a capitalism society is usually to create rules and promote economic prosperity based on those rules. Free market means that playing the fair game within those rules then the prosperity will come. That is exactly what the state and municipalities should do now, in addition to whatever efforts that would come out of Washington DC, so that the free market investors will come back in, out of their own will, to help rescue the local state, county and city economy by stabilizing local property value if they think that these state, county and city governments are willing to make the proactive efforts to restore the local economic prosperity and make proactive efforts to invite new investment capital into the local communities. In another word, the investors should be made comfortable through the participation of the local governments that they will be able to secure the potential return in the future that they deserve by taking the risks now. Or else, this free market capital will simply go somewhere else where they feel more comfortable.

To understand the significance of the future roles of the local governments and a decentralized homeowners' credit risk decision making mechanism in a new national housing finance system, first let's look at a few technical aspects of what the conventional mortgage

really is. From a business risk management perspective, a conventional mortgage has financial risks, legal risk and operational risk for its providers. Within the financial risks there are credit risk, interest rate risk, prepayment risk and real estate market or property value risk all combined and mingled into one single financial product. The key to solve the current default/foreclosure crisis and to establish a healthy new housing finance system is to quantify and single out each of the four types of financial risks out of the conventional mortgage and manage them separately in a new approach.

When each individual risk of the home mortgage is properly identified and addressed by this “divide and conquer” approach, the chance of a potential systemic risk in the housing finance system that could bring down our banking system again in the future could be minimized dramatically.

The interest rate risk will no doubt continue to be managed at the national level by the Federal Reserve or a central bank equivalent. The prepayment risk may be able to continue to keep the securitization game going and many in the industry employed. Both of these two risks will also continue to provide the investors the guessing games either through the secondary whole loans market or the new incarnation of a “Covered Bonds” market borrowed from certain European countries. The real estate market or property value risk will be best managed by the new SwapRentSM methodology to extract them out of a conventional mortgage. That new concept is fully explained in the www.SwapRent.com web site and many other publications. It will not be repeated here since it is not a focus of this article. Local governments at all levels, on the other hand, will be the best candidates to participate to assume an active role to manage the homeowner credit risk since they have the vested interests and the geographical convenience to perform the due diligence required to ensure a sound new housing finance system.

The emphasis here is to create a new role or to expand some existing practices for the local governments to assume a stronger economic function of policing the granting of credit to homeowners and get compensated for it either as a non-profit agency or as a for profit entity similar to Fannie and Freddie.

There are many ways this new role could be accomplished. The simplest way may be to assume the modified but similar mortgage insurance function of the FHA without the capital providing function rather than underwriting the entire mortgages directly that the Fannie and Freddie have been doing. They could set up new local state agencies to perform those similar roles of Fannie and Freddie at the local level and they could be called SSEs (State Sponsored Enterprises) or LGSEs (Local Government Sponsored Enterprises). The modified state version of a new Fannie or Freddie so to speak, with the homeowner credit decisions made at state or even county and city levels. Critical mass and scale of the operations could be accomplished through re-insurance at a national level or to private sector entities. In fact, at most states the state housing finance agencies may not be new but we should let them take on more active new roles. Extra care should be taken for the local governments not to repeat Fannie and Freddie's many mistakes and abuses.

This new involvement by the local governments will not crowd out the existing private sector business by the financial institutions and will only perform the complementary functions that the original intentions of Fannie and Freddie were set out to deliver.

The main benefits of this approach will speak for themselves. Real estate business will go back to a be a regional or localized business as they used to be and where they belong. The unscrupulous behaviors of a few individuals in the mortgage system will no longer affect us as a nation. This could easily be understood if you look back at what had happened within the last few years. The disconnect of credit risk monitoring brought about by the securitization business and the personal abuse of the system by some mortgage brokers and underwriters had quickly brought the whole country down. Moral hazards were created by these centralized housing finance agencies. National monetary policies were held hostage by these inter-linked nation-wide epidemics. Forced low interest rate policies then brought about the sinking US dollar and the ensuing run away inflation led by high commodity prices ... etc.

By having the credit risk management function performed at the local levels with different regional decisions being made independently we could have a much more diversified, resilient and stronger national economy. Economic problems such as what had happened recently could be compartmentalized at a regional level and will not trigger the ominous collapse of the entire empire that many wise guys having been predicting. National monetary policies and fiscal policies will no longer be held hostage by their failures since incompetent or abusive local housing finance agencies or these new SSEs could be punished and left hung dry without batting an eyelid by the politicians. "Too big to fail" will also no longer be a common phrase for the lobbyists or a convenient excuse for the special interest groups. Taxpayer bailout may be reduced to a regional or state issue. Pensioners in Norway, small bank depositors in Germany or central banks in China and around the world may also finally get to be spared by the consequences of local American's credit indulgence.

To further use an analogy to compare practices in other countries, it may make sense to have one single interest rate policy for the entire Euro zone, but try to imagine how ridiculous that could be to set up one Europe-wide agency to offer mortgage insurance and make homeowners credit granting decisions based on one single standard to all European homeowners from Southern Italy to northern Lapland in Sweden and from remote Romanian villages to metropolitan London area in the UK? That would really be a paradise for the opportunistic local mortgage brokers and underwriters if they could simply sell the mortgage loan credit risks away to a centralized European version of Fannie and Freddie the same way they have been doing in the US all along. Pent up problems would similarly be waiting to explode if this were real. That is how ridiculously all these GSEs in the US have been run in the past and grew to become such humongous monsters.

The recent discussions of borrowing the Covered Bonds market concepts as practiced in certain European countries may offer some cosmetic technical changes to the mortgage securitization practices in the US. If these fundamental credit risk management issues are not properly addressed, letting local underwriters continue to sell homeowners default risks away to a centralized agency, developing a new Covered Bonds market will not be able to help

change the situation. Changes in the technicality of the securitization process and methodologies may be helpful but the real evil is the idea of a centralized GSE itself to let the local underwriters off the hook so easily. Credit risk underwriting and monitoring will have to be kept locally, either with the original underwriters or with somebody who may have assumed these homeowner credit default risks subsequently but could continue to make decisions on monitoring and taking rescuing measures when necessary.

Put simply, accountability and responsibility of underwriting these credit risks should not be sold away or securitized away to people who do not have the ability to perform ongoing management. The responsibility of granting credit risks to homeowners and performing ongoing monitoring, in whole or in part, has to stay local with either the financial institutions or the local governments. Equipped with the flexible new housing affordability tools such as SwapRentSM and its embedded new mortgage products (HELM), they could also further provide timely assistance to financially distressed homeowners on an on-going basis. All this will happen naturally because they are made and remain the risk holders and will have the natural motivation to perform the required due diligence of risk underwriting and subsequent risk monitoring.

There seems to be many further research opportunities of the details in this de-centralizing or localizing of homeowner credit risk decision making process could be pursued. There also appears to be many options on how this could be best executed, both through the way how the mortgage credit risk insurance practice by financial institutions are structured and a much more active participation by the local governments in the housing finance process in order to set up a stronger and healthier new national housing finance system. Creating new State Sponsored Enterprises (SSEs) or LGSEs is just one of such ideas meant to be seeds for further discussions and debates.

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Ralph Y. Liu is CEO of Advanced e-Financial Technologies (<http://www.SwapRent.com>). AeFT has been a major provider for innovations in real estate derivatives and consumer housing finance products since 2001. It has pioneered the development of many consumer financial products such as SwapRentSM and its embedded mortgage product, Home Equity Locking Mortgage (HELM). Through its REIDeX.com subsidiary, it provides a centralized marketplace for the trading of SwapRentSM contracts for both homeowners and investors.