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Is Securitization All It's Cracked Up To Be?

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In order to repair the broken mortgage finance system in America, the industry should return to an "originate-and-hold" model and eschew securitizations and government guarantees of credit risk, according to Mark Calabria, director of financial regulation studies at the Cato Institute, in an essay published by Urban Institute titled "Coming Full Circle on Mortgage Finance."

One of the problems Calabria cited with the current mortgage finance system is the massive leverage on the part of financial institutions, which was largely the result of the interaction of Basel III capital accords and mortgage securitization. Calling securitization a "false god that failed us," Calabria stated that the virtues of securitization have been exaggerated, if not illusionary, and that its costs have been hidden or ignored—just like government guarantees of credit risk.

"Hiding costs rarely reduces them," Calabria said. "Painful experience has continued to show the opposite. A more stable and affordable housing market would be best served by returning to an originate-and-hold model of mortgage finance. The recent crisis revealed that securitization has largely been a capital arbitrage that simply shuffled mortgages around from one balance sheet to another. We should not forget that. Mortgages, under any system, have to rest on someone's balance sheet. Like water running downhill, the risk has flowed to the most leveraged sectors of our financial system. This is a recipe for instability."

Despite the claims that the current mortgage finance system has worked for more than 80 years, Cababria said the current securitization-based system arose out of the savings and loan crisis of the early 1980s. Prior to that time, most mortgages were held as whole loans on depositories' balance sheets and insurance companies held most of the remaining loans. It was not until around 1980 that the securitized share reached double digits, Calabria said.

"When the (securitization-based) system was first tested in a housing downturn, it failed," Calabria said. "It would be more accurate to say that the current securitization-based system has never survived a housing downturn, rather than to claim long-standing stability."

The current system has also failed to increase the homeownership rate, which is lower now than it was before the securitization era—and the racial gap in homeownership is at a 100-year high, according to Calabria. The widening of the racial homeownership gap has coincided with the securitization era—the gap was at its lowest in 1980, the beginning of the securitization era.

Calabria also argues that investor due diligence in underlying mortgages has been replaced by regulators and lawmakers, and that financial reform laws such as Dodd-Frank are unlikely to increase credit availabilityand may in fact increase mortgage delinquencies during the next downturn.

"We have a system, as we did leading into the crisis, where investors did not either care or know about the underlying credit risk," Calabria said. "While some might see that as a critical feature of the system and one to be preserved, I believe it is the most fundamental flaw of our system. A system where investors do not care about credit risk is one where toxic mortgages are not only allowed but encouraged."

While advocating a return to the originate-and-hold model, as the secondary market goes, Calabria suggests that current GSE charters should be converted to national bank charters and that the GSEs should then be recognized as bank holding companies (BHCs).

"Not only could the GSEs continue to pool and securitize mortgages as BHCs, but they could also originate, collect deposits, and engage in other bank activities," Calabria said. "Given the high concentration among the largest banks, adding two large BHCs would immediately bring increased competition to that market. It would level the playing field between the GSEs and the largest banks, in both directions."

While defenders of securitization claim there would not be sufficient funding for the mortgage market without it, Calabria countered with, "This claim ignores that funding for the secondary market must come from somewhere. For the most part, it has come from the institutions it was supposed to have replaced."

Calabria contends that the most critical elements of a functioning market are respect for property and contract, and while foreclosures are tragic, a system that does not allow the ability to foreclose on underlying collateral would be worse. But the system is moving in the direction which makes legitimate foreclosure more and more difficult, Calabria said.

"If we wish to see mortgage credit widely available, litigation risk must be reduced," Calabria said. "As researchers at the Federal Reserve Bank of Richmond have demonstrated, consumer 'protection' policies that appear on the surface to help borrowers can actually leave those borrowers worse off."

The only way to fix the mortgage finance system is to address the fundamental flaws; modest or small tweaks will only be pushing off the problem until the next housing market downturn—which Calabria said is inevitable.

Calabria's essay is the seventh in the Urban Institute's Housing Reform Incubator. Click here to read the full essay.