

Mortgage debt, the financial crisis, and what to do next

Prof. Stijn Van Nieuwerburgh

NYU Stern Finance Department

Director Center for Real Estate Finance Research

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Mortgage debt as a source of financial fragility

Mortgages have become key asset of levered financial institutions

1. 90%+ leverage and increasingly systemic nature of house price risk
→ **financial fragility** and financial crises like the 2007-10 GFC

2. Financial fragility affects real economy:

- a. by restricting bank lending to non-financial firms ex-post
- b. by imposing large bailout costs on government and taxpayers ex-post
- c. by raising cost of mortgage and corporate credit ex-ante
- d. by shrinking the amount of financial intermediation done (“pipes”)

The role of the government in financial fragility

Financial fragility affected by government which plays large role in banking sector and in mortgage markets

1. Deposit insurance and too-big-to-fail **government guarantees to financial sector**
 - a. Necessary to avoid bank runs
 - b. But distort risk-taking incentives: privatize gains, socialize the losses
 - c. Regulatory capital requirements limit risk-taking but shrink the size of the intermediary sector (pipes) and are easy to game in practice
 - d. Macro-prudential policy must be carefully calibrated to achieve “right” trade-off between conflicting goals of minimizing fragility and maximizing “pipes”
2. **Fannie Mae and Freddie Mac** (now part of government) take up much of the default risk in U.S. mortgage market by offering underpriced default insurance to banks
 - a. Distorts bank risk-taking incentives: take more leverage, make riskier loans
 - b. End up with even more fragile sector

The Next Debt Crisis

Tight lending standards and economic recovery resulted in record low residential mortgage defaults in last five years. Next crisis likely to come from elsewhere.

1. Commercial real estate highly valued, even relative to stocks and bonds
 - a. Has become more interest rate sensitive, just when rates are likely to rise
 - b. CRE debt mostly held by (regional) banks, has Fed worried
 - c. Relaxation of lending standards in search for yield
 - d. Competition from non-bank lenders (mezz lenders, REITS, pension funds, etc.)
2. High yield corporate debt
 - a. Increased prevalence of “covenant-lite” junk bonds, far exceeding 2007 levels
 - b. PE funds with access to cheap debt paying large multiples for ordinary firms in search for yield → PE funds as shadow banks
3. Local government debt in China, often tied to value of real estate/land

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