The Economics of Housing Finance Reform

by Scharfstein and Sunderam

Discussion by Viral V Acharya (NYU-Stern, CEPR and NBER)

A nice contribution!

- Makes several useful points

1. Government guarantees in good times are unnecessary, unlikely to make home ownership cheaper, and will likely create moral hazard even if in private partnership

2. Privatization too does not eliminate moral hazard, concentrates all mortgage risk in banking sector, and increases flawed private-label securitization

Proposal

1. Almost all times: Entirely private market but with strong regulation of underwriting quality, bank capitalization and the capital structure of securitization products

2. Catastrophic risk: Government corporation that is self-funded and provides (only) "guarantor of last resort" function to the housing market
   - *De minimis* role all other times to be able to be guarantor of last resort

Transition issues acknowledged as important but discussed only briefly…

GUARANTEED TO FAIL

FANNIE MAE, FREDDIE MAC
and the Debacle of Mortgage Finance

VIRAL ACHARYA
MATTHEW RICHARDSON
STIJN VAN NIEUWERBURGH
LAWRENCE J. WHITE

Some tough questions

1. What is the "catastrophic risk"? Is it exogenous to financial sector choices (pure "panic") or endogenous?

2. Is the "market failure" that financial sector had not set aside enough capital to provide intermediation? If so, doesn't the market failure get worse with the provision of a guarantor-of-last-resort (crowds out private sector, unlike deposit insurance)?

3. Capital tends to be slow-moving when there is an aggregate crisis. It acquires expertise as opportunities arise. Such investment in expertise takes time but less so if returns are high.

4. (How) Will the guarantor exit? Until exit, does it get larger and larger? Does that make graceful exit harder? Does that delay the entry of new capital and investment in expertise/infrastructure for the private sector to take over?

5. (GTF proposal) If the guarantor operates at an effective cost of capital – or a cost of guarantees – that is same as that of the private sector, e.g., by being a passive partner in the business, would the crowding-out problem be mitigated?

Is the government at risk?

1. Most financial sector reform proposals with a "catastrophic risk" state have a salubrious role for government guarantees

2. Such role must model or discuss the risk of sovereign's fiscal condition to take on additional risks in that catastrophic risk state
   - In some cases, capacity may be high (Norway); in others low (Spain, Ireland); in some others moderate now (United States), but low in future "Icelandic" scenarios

3. Would it be better to provide some lender-of-last-resort (Fed), for an appropriate fee, to the private sector to come in, so that the mortgage risk is not all on the government?

4. Did the sovereign set aside enough "capital" in good times to correct the market failure? If not, will the guarantor effectively ensure there is neither private nor public capital when the catastrophic risk state involves government risk?

   - Maintaining underwriting standards helps, but quantities could get large if the state persists…

5. Financial sector reforms, going forward, should involve discussion of ex-post fiscal costs, sovereign credit risk, and the two-way feedbacks