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The Government's Role in the Housing Finance System: Where Do We Go From Here?

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Brookings Institution
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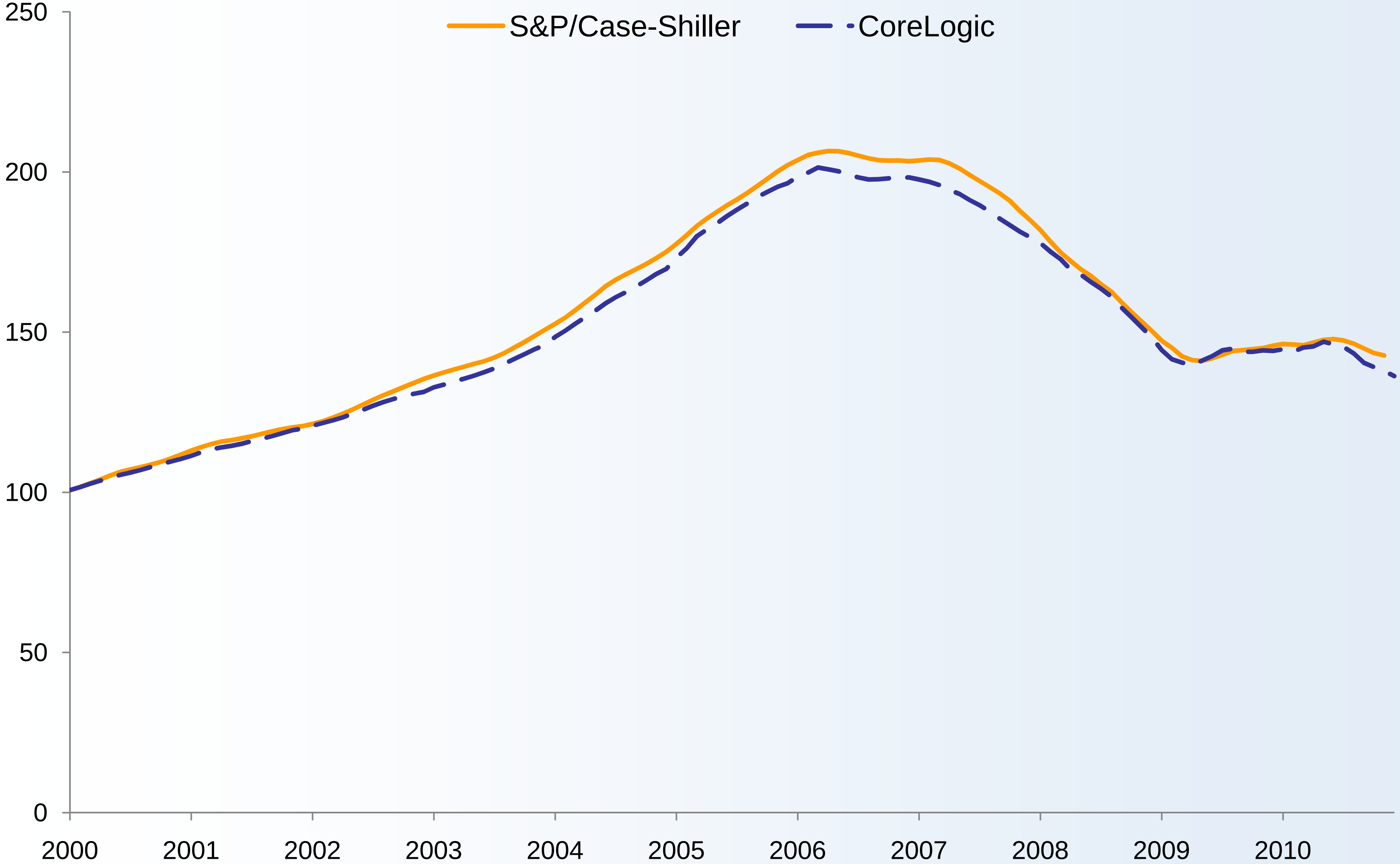
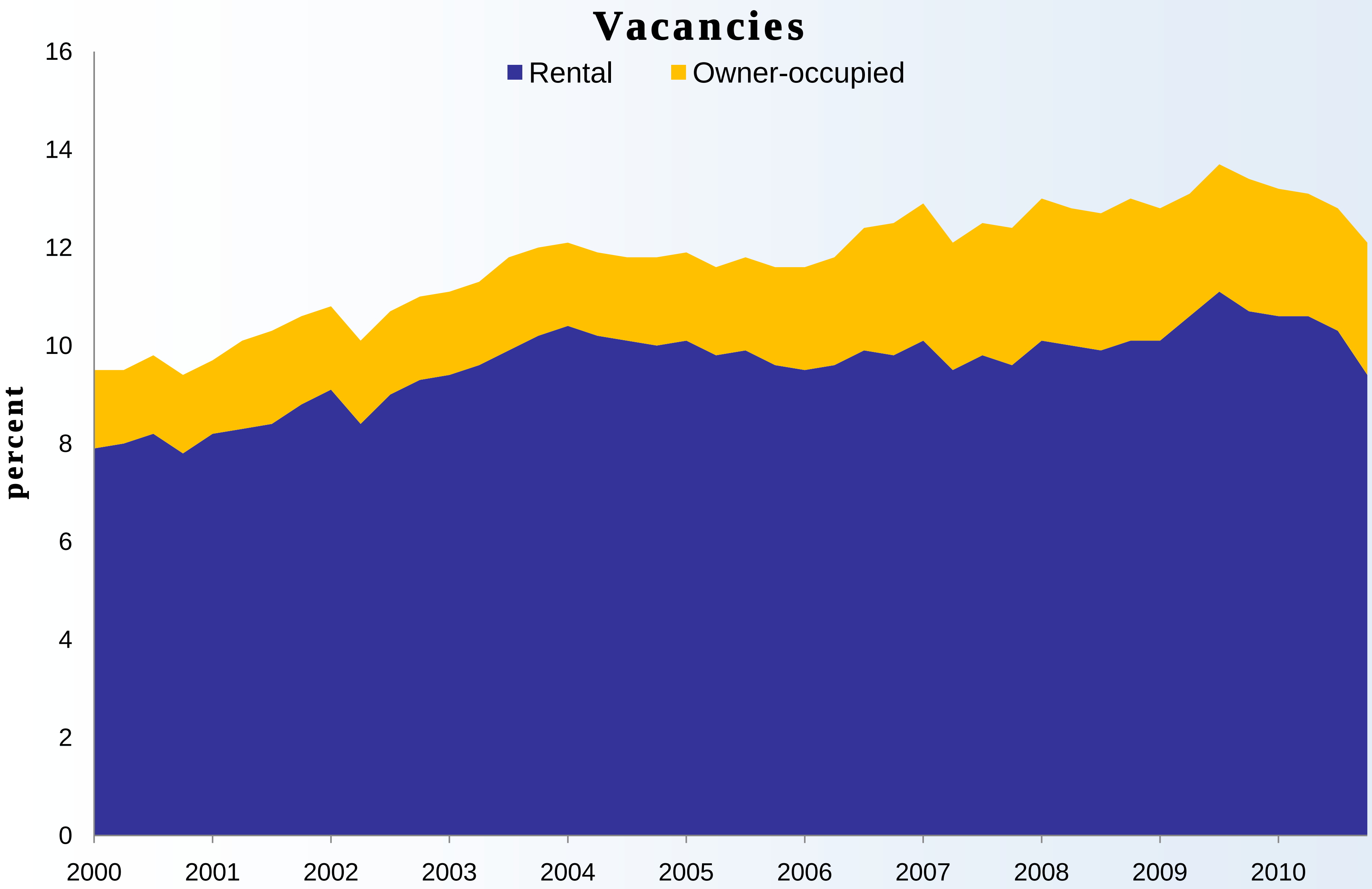
Home Prices



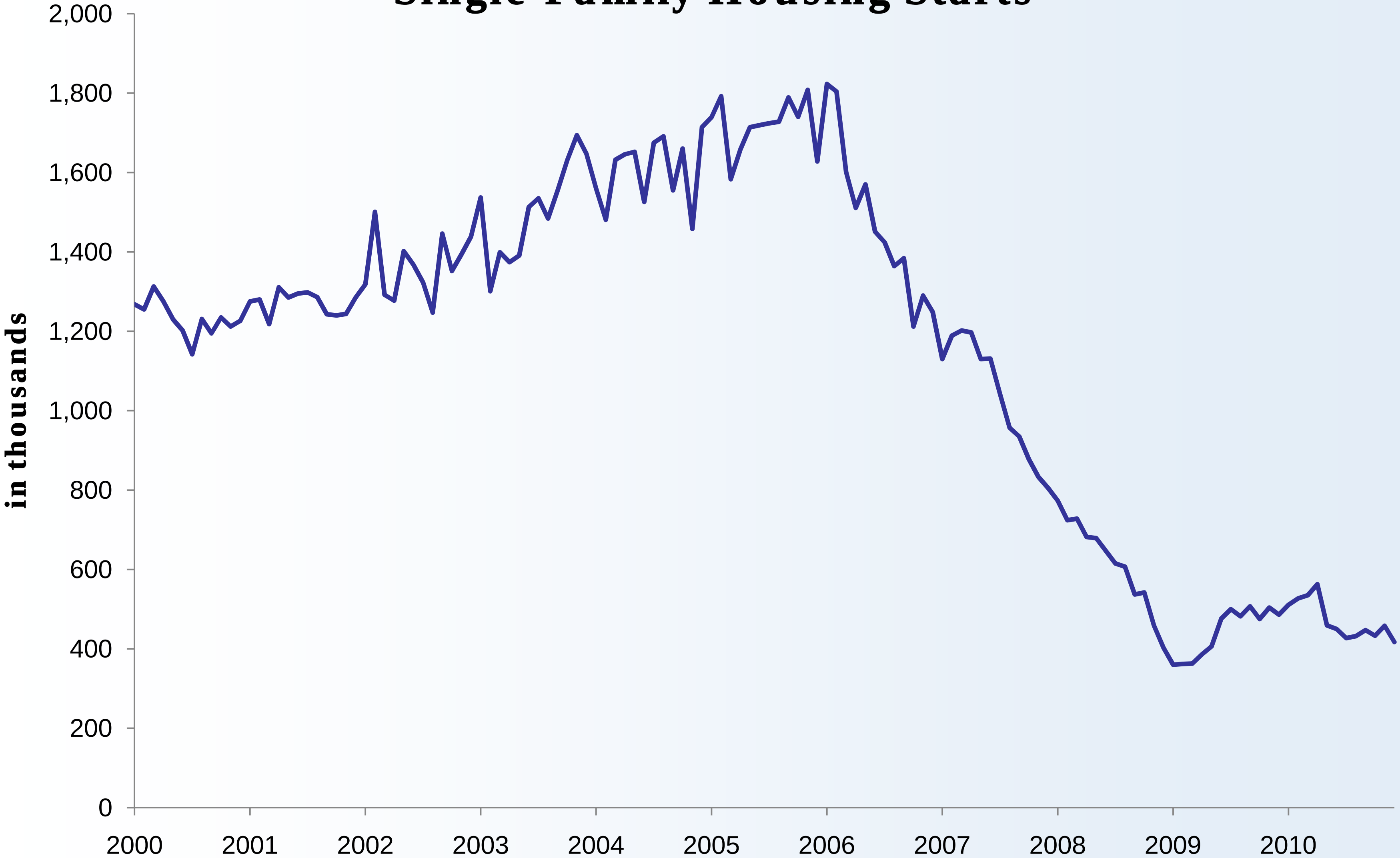
SA, Jan 2000=100

Source: S&P and CoreLogic/Haver Analytics



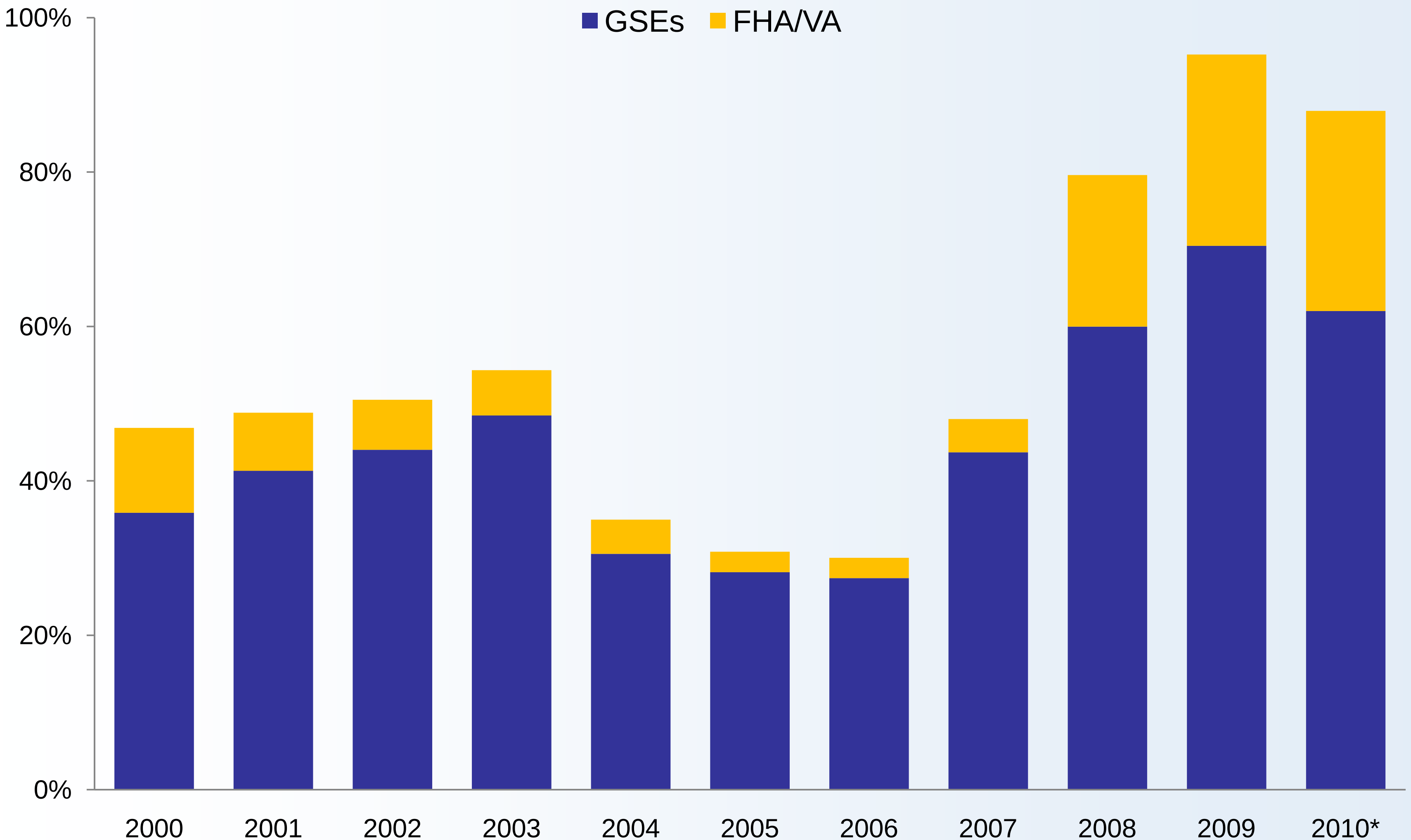
Source: Census Bureau/Haver Analytics

Single-Family Housing Starts



Source: Census Bureau/Haver Analytics

Share of Originations



*through 3rd quarter

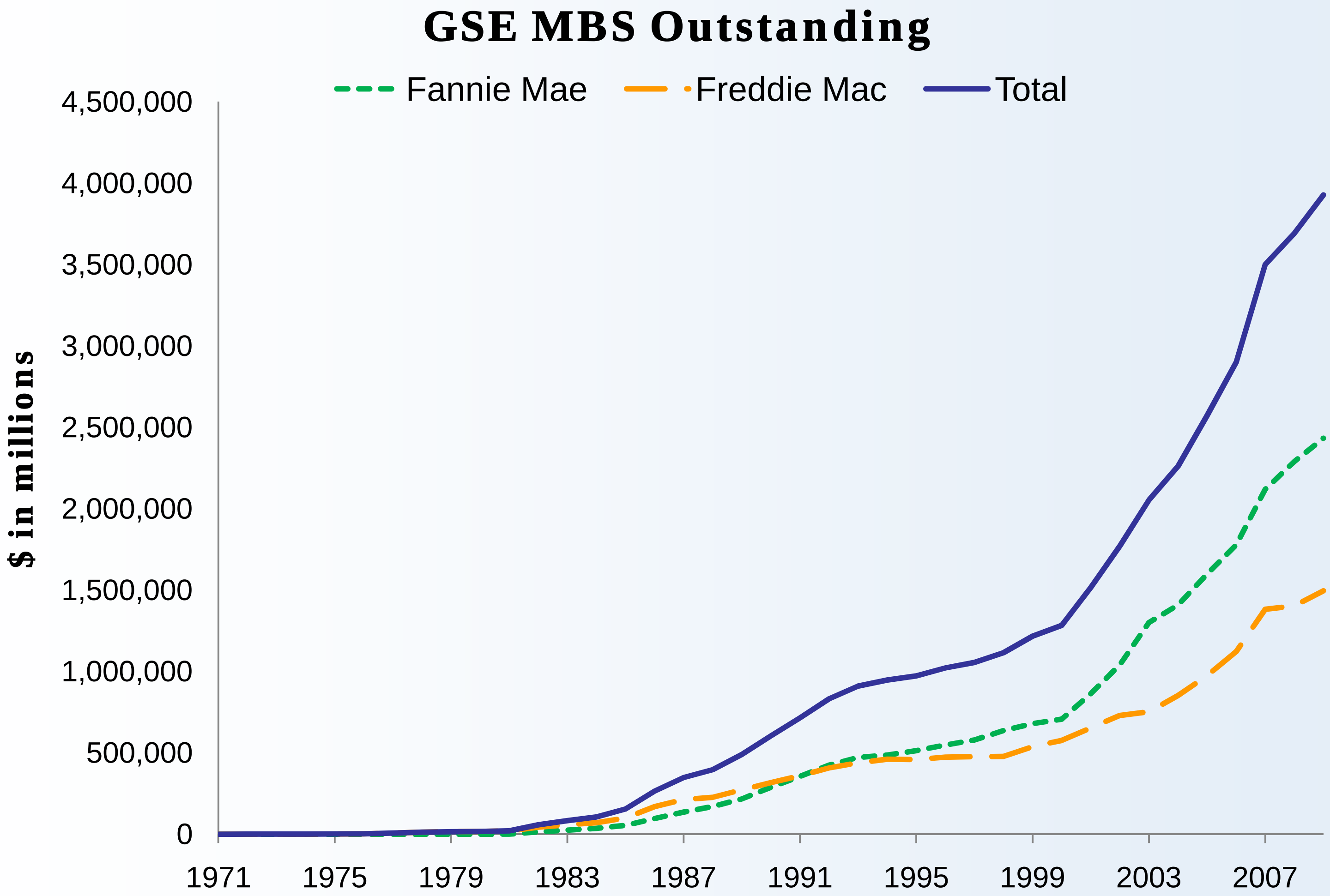
Source: Inside Mortgage Finance

Current housing market conditions may warrant a gradual transition, but the time to commit to a new plan is now.

GSEs under the Pre-Crisis Model

- Privately owned but with government mission
- Issued government-guaranteed MBS backed by “conforming” mortgage loans in exchange for fees covering administrative costs and expected cost of guarantee
- Held portfolios of mortgage-related assets
- Met “affordable housing goals” specifying what fractions of mortgage acquisitions should finance housing for certain underserved groups

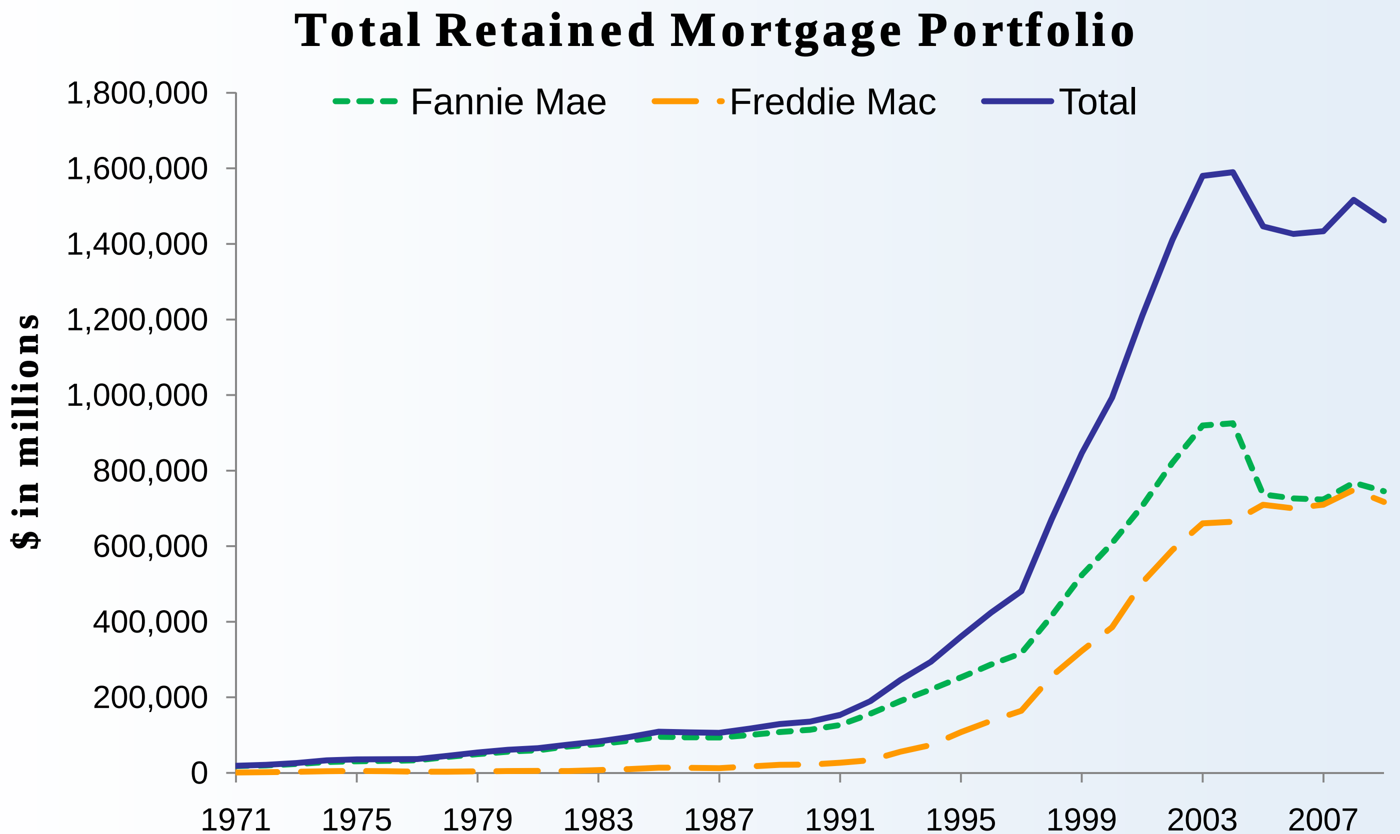
Precursors to Trouble (1):
Rapid growth of GSE guarantees during mortgage boom



Source: FHFA

Precursors to Trouble (2):
Rapid growth of portfolios

Fostered by an "implicit government guarantee" that made it cheap to borrow to finance portfolio

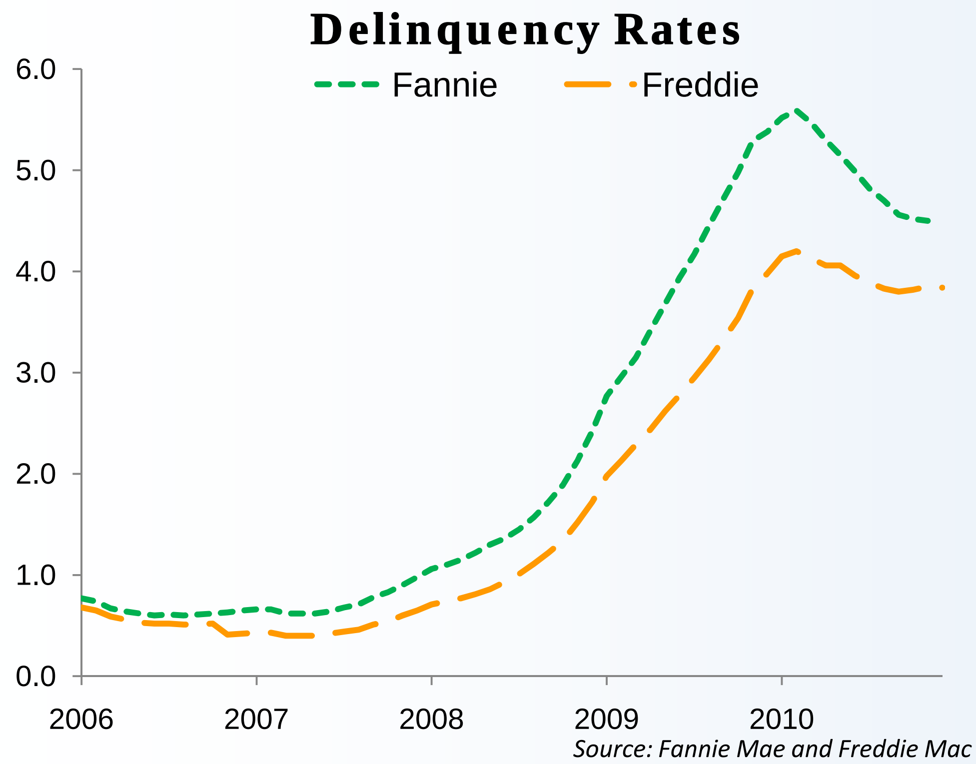


Source: FHFA

Precursors to Trouble (3):
Other factors

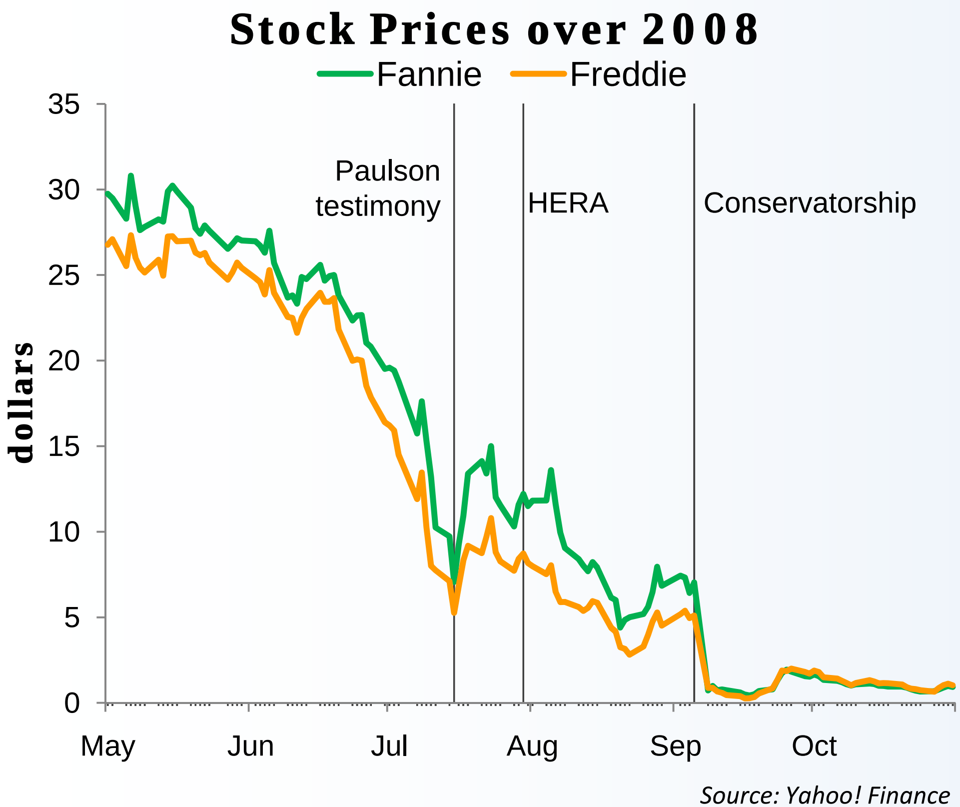
- Affordable housing goals and desire for high returns encouraged acquisition of securities backed by riskier mortgages (subprime and alt-A) for portfolio
- Weak regulator
- Lack of market discipline

Trouble



Substantial losses on nonprime MBS in portfolio as well but those holdings smaller than the value of mortgages guaranteed

The Portfolios Ultimately Catalyzed the September 2008 Government Take-Over



- The summer of 2008 saw deteriorating investor confidence about GSEs' ability to weather their credit losses
- Systemic concerns rooted in increasing cost and difficulty of rolling over the short-term debt that largely financed the portfolios

The Role for Government in the New Mortgage Finance System

The government's role should be limited to providing credit guarantees on mortgage-backed securities funded by premiums that are (at least) actuarially fair.

- Economic justification for guarantees: Risk-averse individuals will want to fully insure against a possible loss of income if offered an actuarially fair premium. Such insurance provides liquidity and can limit volatility in secondary market.

- Why not leave it to private insurers?
  - » Difficult to pool risk when defaults are not independent across insured parties
  - » Massive government intervention over past few years ► investors will believe there is an implicit guarantee anyway ► risk continues to be underpriced

Key Specific (1):

Government efforts to promote affordable housing must be separated from government efforts to guarantee mortgages

- Affordable housing goals can lead to political pressures that contribute to the under-pricing of credit guarantees.
- Evidence suggests that GSEs had only a limited effect on the supply of affordable housing.

⇒ Efforts to promote affordable housing should occur through FHA and direct, explicitly-funded assistance to targeted households.

Key Specific (2):
Scope of guarantee should be limited

- Need to be sensitive to risk of government failure:
  - » Political pressures + sheer difficulty of accurately pricing sophisticated financial instruments create risk of under-pricing guarantees
- Implies guarantee should be limited to easily priced, “plain vanilla,” high quality mortgages
  - » Rather than rely on sophisticated underwriting models that are at risk of mispricing, better to restrict the guarantee to mortgages that meet simple parameters in terms of maximum cumulative loan-to-value, degree of income documentation, and minimum credit scores.
- Other types of mortgages still will be available, just not guaranteed by government (and, of course, subject to tighter regulations than before the crisis).

Key Specific (3):
Fairly competitive secondary market structure

- Private firms are able to buy mortgages and issue MBS with the (at least) actuarially fair government guarantee.
- Restricting guarantee to plain vanilla mortgages means many firms can compete …
  - » Mitigates concerns about limited ability to monitor individual firms
  - » Enhances likelihood that the resulting securities will be viewed as homogenous, increasing their liquidity and thereby lowering mortgage costs.
- More competitive market should not foster perceptions of implicit guarantee for these firms, limiting need for special portfolio restrictions.

Summary

- Needs to be (at least) actuarially fair to limit risk to taxpayers
- As a practical matter, this means:
  - » The activity cannot be conducted by entities engaged in promoting affordable housing through subsidies
  - » The guarantees need to be restricted to mortgages that are easily recognized, easily priced ("plain vanilla")
  - » This will likely raise the cost of mortgages somewhat (though they'll still be lower than in a fully private market) and the number of borrowers covered but the government will not be exacerbating credit booms and their risks.
- Given restriction, the business of securitizing mortgages can be opened to many firms