Comments on

“The Government’s Role in the Housing Finance System” by Karen Dynan and Ted Grayer

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Overview

- The paper contains approximately two equal parts. The first half reviews the subprime crisis to the present.

  U.S. economic policy is always path dependent, so it is always critical to know where we were and are.

  I agree with almost all their descriptions, a bit less with some of the implications they draw.

- The second half provides a specific proposal for the government to guarantee a set of U.S. mortgages.

  Here I disagree more emphatically, as I will explain.

The Timing of Mortgage Reform

- The paper properly emphasizes the current overhang of vacant units. Indeed, about 12 million housing units were constructed during the decade of the 2000s.

  Making these units affordable is clearly a critical goal.

- The weak state of the housing market, however, is not an excuse to delay mortgage market reform.
  - The paper argues for a "gradual transition". I agree.
  - The government's use of the GSEs to subsidize loan modifications and refis is just delaying true reform.

The GSEs: May They Rest in Peace

- The paper identifies both areas of major GSE risk-taking:
  - Credit risk-taking expanded the subprime boom/bust.
  - Actual failure due to asset/liability liquidity mismatch.
  - Jaffee (2003): “.. if investors refuse to purchase new F&F debt…F&F fail to payoff their maturing debt, creating <u>a major financial crisis or bailout</u>.”
- The GSE Housing Goals were not a major factor in motivating the GSE subprime participation.
- Quibble: paper incorrectly states that the Accounting Crisis at both GSEs is evidence of OFHEO’s weakness.

The Dynan and Grayer Proposal

- Federal government should provide mortgage insurance, apparently without limit, as long as the loans are high quality, meeting strong requirements for LTV, FICO score, and income documentation.
- The insurance should be priced to be actuarially fair.
- GSE affordable housing mission transferred to government entities, such as FHA and HUD.
- Government guaranteed mortgages would be securitized by private financial institutions.

<u>Immediate comment</u>: Why not just use GNMA? Indeed, it seems just extension of FHA/GNMA.

The Case for Government Insurance

- Dynan and Gayer:

  “The economic justification for a government role in providing insurance is that private insurers will fail to pool risk appropriately when the risk of default is not independent across the insured …..”

“But given the massive amount of government intervention in the financial markets these past years….the market undoubtedly assumes a future and ongoing implicit guarantee.

Catastrophe Insurance: TRIA

- This would put private investors in first-loss position, while government insures against systemic melt-down.
- The Terrorist Risk Insurance ACT (TRIA) provides an excellent example.
  - Create in 2002 with a five year termination, it has been renewed 3 times.
  - The premium charged is zero.
  - But it only protects against a true catastrophe.
  - It seems to have worked.
- The devil is in the details.

The Case Against Government Insurance

- Private market securitization is designed precisely to distribute risk across a wide range of investors, while allocating the highest risk to the most risk tolerant.
- The problem with government insurance is that, inevitably, it encourages <u>excessive risk taking</u>:
  - Most government insurance requires actuarial premiums.
  - But government insurance cannot exclude higher risks.
  - Government insurance never achieves risk-based prices.
  - Minimum is cross subsidization; usually full subsidy.
  - Government subsidies put taxpayers in harm's way.

A Private Mortgage Market Proposal (Jaffee, WSJ, 10/25/2010)

- Basic principle: In absence of a market failure, private markets generally dominate government.
- FHA/HUD programs should continue to support low-income, first-time, homebuyers and multifamily.
- Transition plan: Reduce conforming loan limit by \$100,000 annually until it reaches zero. Allow existing balance sheet portfolio just to run off.
- Safety net: FHA and GNMA could be rapidly expanded for conforming mortgages if needed.

Comparing 15 European countries and the U.S. for market performance:

- Home ownership rates: U.S. is 8^{th} of 16.
- Housing Start Volatility: U.S. is 5^{th} of 16.
- House Price Volatility: U.S. is 4^{th} of 16.
- Mortgage rate spread: U.S. is 5th of 16.
- Mortgages outstanding/GDP: U.S. is 5^{th} of 16.

A Private Market will Provide a Large Menu and Safe Mortgages

- Private mortgage market will provide borrowers with large menu of safe mortgage choices:
  - Adjustable or fixed rate; prepayment penalties or not;
  - Options for amortization, maturity, and recourse.
- Safer mortgages will mean <u>lower interest rates!</u>
  - Loan to value ratios will likely be lower;
  - <u>Securitization</u> can continue as earlier: remember, no bailouts were provided to MBS investors.
  - <u>Covered bonds</u> may also arise. In any case, bank regulators must improve their oversight.