# Catastrophic Mortgage Insurance and the Reform of Fannie and Freddie

Comments

**John Quigley**
University of California
Berkeley

Brookings Institution

February 2011

# Hancock-Passmore Proposal

"New" Federal institution designed to provide catastrophe insurance -- to insure some segment of the mortgage market against default.

The basic argument:

**The liquidity provided by the securitization of mortgages comes with the potential of a "run on the bank."**

# More specifically:

| | |
|---|---|
| If | investors doubt the quality of mortgage-backed instruments, |
| then | risk premiums increase for those instruments, |
| then | new mortgage-backed instruments are not issued, |
| then | lending standards for mortgages increase, |
| then | credit is tightened, |
| then… | |

The Big Issue in evaluating this proposed new institution is:

**Compared to what?**

Compared to: the current government insurance provided to virtually all mortgages through the conservatorship of Fannie Mae and Freddie Mac?

Or to: a reform that would eliminate these Government Sponsored Enterprises and put their functions in private hands?

Something in-between?

## At one extreme: compared to the current conservatorship?

Hancock-Passmore Proposal is certainly preferred.

Explicit pricing of catastrophe insurance instead of implicit and unpriced guarantees of government insurance.

Explicit government underwriting standards and explicit compensation to government for risks borne.

## At the other extreme: compared to a purely private set of mortgage market actors?

The advantage of the Hancock-Passmore Proposal is much less clear.

In essence, the H-P Proposal is to keep the current structure of Fannie and Freddie in place with two changes:

1. Eliminate the right of F&F to retain whole mortgages or mortgage-backed securities in portfolio

2. Require F&F to purchase and securitize only mortgages with much lower loan-to-value ratios, say 40%

# Private comparison is surely the relevant one

Empirical evidence provides little support for government insurance.

Government-supplied catastrophe insurance:

1. National Flood Insurance Program: encourages reinvestment in unsafe flood plains?

2. Pension Benefit Guarantee Program: shifts risks to taxpayers through premium policies?

Any reason to expect this new program to perform "better?"

- Development of national mortgage market over 75 years is the major accomplishment:
  - Underwriting
  - Standardization
  - Securitization
- Would this capital go away if F&F were not replaced by any institution at all?
  - Private Mortgage Insurance
  - Private Label Mortgages
- Experience elsewhere?

## The real "problem" in a private solution is that underwriting standards will rationalize and will rise.

Mortgages will be more expensive.

1. Rates will increase, on average, by 25-30 bps.
2. And relative riskiness will now be reflected in pricing.

Do we want to continue subsidizing certain classes of borrowers?

**If so, this subsidy can be administered explicitly and inexpensively through the FHA – which has also been around for 75 years.**