The Economics of Housing Finance Reform:
Privatizing, Regulating and Backstopping Mortgage Markets

David Scharfstein
Harvard and NBER

Adi Sunderam
Harvard

Conference on
Restructuring the U.S. Residential Mortgage Market
Brookings Institution
February 11, 2011

The Administration Proposal

- Wind down Fannie Mae and Freddie Mac
- Better regulation of private mortgage credit
- Three options for replacing Fannie and Freddie
  - Private markets
  - Broad-based private mortgage guarantees with explicit, priced government reinsurance of MBS
  - Private markets + Government guarantor of last resort

Broad-Based Guarantee Option

- *Properly priced* guarantees have limited effect on mortgage rates in normal times.

- Government guarantee advocates make two assumptions:
  - Government only charges for expected guarantee losses, no risk premium to compensate for risk.
  - Private entities who hold/guarantee mortgages charge very high (25%) risk premiums.

- Both assumptions are flawed:
  - Government as agent of taxpayers should charge the same risk premium as investors would.
  - Well-underwritten, prime mortgages are not very risky.
  - Only potential benefit is small liquidity premium (10-20 bps).

Broad-Based Guarantee Option

- Lowering MBS yields may not be effective
  - Market power means guarantors/originators may not pass cost savings through to borrowers.
  - Lower mortgage rates increase house prices so monthly payments may not be very different
- Lower MBS yields may distort household investment
  - Already distorted by mortgage interest deduction
- Private firms with USG backstop create moral hazard problems
- Private capital will be wiped out in a crisis, so bailouts will be necessary to continue flow of mortgage credit

Financial Stability as Housing Finance Reform Goal

Reduce excessive volatility in the supply of housing credit and protect the financial system from adverse shocks to the housing market.

↓

- Limit boom and bust cycles in mortgage finance

- Protect the rest of the financial system from housing market collapse

- Support mortgage markets when most needed – during periods of significant financial stress

Regulated Private Markets

- Financial stability goal met by tight underwriting standards
  - Policymakers have to trade off financial stability and other housing policy goals such as mortgage credit availability
- Regulation of risky mortgage products
- Bank capital requirements
- Regulation of securitization

Regulated Securitization

- Limits on securitization of risky mortgages
- “Vertical Strips” for securitization of riskier mortgages
- Limits on size of senior tranche to ensure true safety
- Limits on re-securitization
- Promote standardization of securitization

The Guarantor of Last Resort

- Support mortgage markets during periods of significant financial stress via a government-owned corporation that would guarantee MBS.
  - Goal is to ensure continued availability of mortgage credit, not bail out investors.

- Maintain small footprint (< 10%) in normal times so guaranty capability exists in crisis and losses are limited

- Auction guarantees with reserve guarantee fee.

- Government ownership reduces incentive to chase profits