1

The Federal Role in Housing Finance: Principal Issues and Policy Proposals

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Fannie Mae and Freddie Mac dominate the American housing market, backing more than 62 percent of recent new mortgages and holding more than $5 trillion in accumulated mortgage risk. Unfortunately, their traditional structure as government-sponsored enterprises (GSEs for short) is clearly broken. The GSEs are a kind of public-private partnership in which private capital, motivated by the pursuit of profits, is channeled toward the accomplishment of government objectives for housing. For a while, the GSEs generated very high earnings while meeting increasingly challenging public goals with no cost registering on the federal budget. However, the structures came crashing down in 2008, requiring a rescue that has effectively given the federal government ownership of the two GSEs in exchange for a projected $224 billion in capital injections and the promise of more, if needed.¹

Fannie Mae and Freddie Mac are coming to a crossroads where the government will have to make key choices about their structure and, indeed, their very existence. This volume is an outgrowth of a conference held by Brookings to better inform these decisions. To begin, this chapter provides some background on the GSEs and the federal role in supporting the U.S. housing market and then summarizes and compares key proposals offered by the remaining chapters. The good news is that these chapters reflect what appears to be a growing

¹. Projection from the president’s proposed budget for 2012 for the maximum cumulative capital injections.
consensus on several public policy issues critical to the design of a restructured housing finance system. This is particularly good news since the authors were chosen to represent a fairly wide range of views and analytical perspectives.

At the same time, important areas of disagreement remain. In addition, it is not clear that the emerging public policy consensus will be that of the politicians who will ultimately determine the fate of the GSEs and the housing market.

The key elements of consensus among the researchers, and with a Treasury white paper outlined at the conference, appear to be the following:

—The federal government has an appropriate role in stabilizing housing finance markets and assisting low- and middle-income home buyers.
—However, the government has been doing too much in this area and doing it too expensively. It should step back and let the private markets do more.
—Mixing credit guarantee and affordability efforts so intimately in the GSEs was a mistake. Going forward, the housing affordability mission should lie with the Federal Housing Administration (FHA), the Department of Housing and Urban Development (HUD), and similar entities.
—Any government credit guarantees, apart from the affordability mission, should be priced explicitly at “actuarially fair” rates and not be provided implicitly at zero cost, as before, or even explicitly but at a low cost.
—Any private credit guarantors with government backing should be severely limited in their ability to own substantial portfolios of mortgages or related securities. This becomes even more important to the extent that such entities have a structural ability to earn arbitrage profits by borrowing at rates close to Treasury rates.
—Any government housing subsidies should be calculated accurately and recorded in the federal budget.
—A multiyear period is needed to transition from the current housing finance regime to any of the proposed ones. Housing finance is too troubled and the GSEs are too important to move immediately, although that does not need to hold back the decisionmaking, just full implementation.

Despite these areas of agreement, the authors disagree about the right structure for the housing finance system, including differences of opinion about the extent of the federal role. Before addressing these areas of disagreement, this chapter offers some background on housing finance in the United States.

Overview of the Federal Role in Housing Finance

The federal government has played an important role in the U.S. housing market since the early 1930s, when a number of programs were set up in response to the Great Depression. The recent housing and financial crisis caused the
government role to expand still further, to the point where it clearly dominates the mortgage market, at least temporarily. As Dynan and Gayer note in chapter 4 of this volume, 88 percent of new mortgages were backed in some manner by the federal government in the first three quarters of 2010, roughly double the average share from 2000 through 2007.

Tax subsidies may be the single strongest, and most expensive, support that the federal government provides. Individuals and couples who itemize their deductions for federal income tax purposes are allowed to deduct the cost of mortgage interest, within fairly wide constraints. The federal government forgoes approximately $100 billion a year in tax revenue as a result, and many states subsidize homeownership in the same way. 2

The federal government also provides mortgage guarantees to a wide swath of Americans through the FHA, the Veterans Administration (VA), the Rural Housing Service of the Department of Agriculture, and other bodies. In addition, the Government National Mortgage Association (Ginnie Mae) guarantees mortgage-backed securities containing mortgages with federal guarantees. These entities were set up to assist either groups who are viewed as particularly worthy of government aid, such as veterans, or low- and middle-income borrowers who are believed to have the financial ability to carry a mortgage, but need help in buying a first home or trading up to a larger home. Critics argue that the latter role has been stretched considerably to include aid for many Americans who could afford homes without the help. In addition, the government sponsored the two GSEs that are described next.

Background on Fannie Mae and Freddie Mac

For decades the government used an unusual form of public-private partnership with the two huge GSEs to achieve key goals in the housing market. Originally, Fannie Mae and Freddie Mac were both wholly owned government corporations. However, the government’s stakes were sold to the public over time, starting under President Lyndon Johnson, apparently primarily for budgetary

2. The conceptual analysis of the subsidy is more complex than normally presented. Ideally, an income tax system matches income with the expenses related to its production, taxing the net difference between the two. Rent payments are taxable to the landlord, net of expenses related to the rental property. Homeowners, however, are not taxed on the value of the “implicit rent” they receive from owning a home, but they are allowed to deduct many expenses related to the production of that implicit rent, including the mortgage interest deduction. Thus the tax subsidy could be eliminated either by taxing the implicit rent or by eliminating the interest and other deductions associated with homeownership. The author is grateful to Bill Gale for his careful explanation of the issue.
reasons. In addition, there were policy arguments that the hybrid form could bring the benefits of a private sector, profit-focused approach while still achieving the broader housing goals. These arguments are similar to those advanced in regard to federal credit programs, such as student loans or FHA mortgages, for guaranteeing private sector lending rather than making direct federal loans.

Each GSE was given a special federal charter, created by an act of Congress, which was intended to provide an element of continuing government control, such as through presidential appointment of a certain number of members of the board of directors, and special privileges that would allow the GSEs to function more effectively and profitably than purely private competitors. Both the government control and the special privileges in the charters were enhanced by additional regulatory actions. These charter provisions and regulations evolved over time. By 2001 the key elements in the balance of government control and special privileges were as follows:

—The board of directors was now completely chosen by the shareholders, with no presidential appointees.

—The Office of Federal Housing Enterprise Oversight, later restructured as the Federal Housing Finance Agency (FHFA), acted as the primary regulator. The agency set capital standards, within congressional rules that locked in fairly light requirements, enforced safety and soundness regulation, and determined whether the GSEs could introduce new products. The FHFA worked in concert with HUD on new product introductions and some other issues.

—Each GSE was given “affordable housing” goals intended to ensure that a stated percentage of the mortgages that it owned or guaranteed were for low- and moderate-income, central city, or rural households. These goals generally rose over time.

—The GSEs were only allowed to purchase mortgage-related assets where the underlying mortgages were for principal amounts below specific limits set by law. In addition, the GSEs imposed additional requirements regarding the form of the mortgage and the underwriting process. Those mortgages that met the legal and other requirements were referred to as “conforming” mortgages.

—GSE debt was treated in a privileged manner that gave the firms a strong advantage in raising funds in large volume at low costs. Most important, banks and some other regulated entities were allowed to treat GSE debt as if it were

3. The sale produced some cash that counted immediately against the growing deficits. More important, credit programs were still budgeted on a cash basis at that point in time, which meant that each dollar of new loan added to the deficit just as much as the purchase of military equipment, for example. Repayments worked in the opposite direction, but the growth of the GSEs would have continued to increase the deficit for years to come.

4. The George W. Bush administration chose not to appoint anyone to the board and proposed eliminating presidential appointments from the charters of the firms.
U.S. government debt for the purposes of calculating risk-based capital requirements. This meant that banks generally needed to hold little or no capital against these instruments, a preference that could be worth 30 basis points annually to a bank. Further, GSE debt was not subject to credit concentration limits at these regulated entities, which could otherwise have constrained their GSE exposure. GSE debt was also settled through the same systems as U.S. Treasury securities.

—The specific debt privileges, combined with the GSEs’ important public policy roles, their special charters, and their origins as government agencies, left investors with the strong impression of an implicit government guarantee of the debt. This, of course, proved to be true in practice. That implicit guarantee further reduced the GSEs’ funding costs.

—GSE capital requirements were calculated differently than the requirements for banks, their closest competitors. Congress clearly sent the message to the regulators, both explicitly and implicitly, that they should calculate the

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5. A bank that was aiming to hold capital equal to 8 percent of risk-based assets, and would otherwise own assets with a risk weighting 25 percentage points higher than that for GSE-backed securities, would avoid allocating capital of 2 percent of the principal amount to this investment. Internal capital charges were generally set at 15 percent or higher, creating an advantage of 30 basis points in this example.
capital needs in ways that gave the GSEs a significant market advantage by letting them put up less capital for each dollar of principal.

The GSEs grew strongly in recent years, until the housing crash, as shown in figure 1-1. The GSEs’ mortgage exposure grew an average of 9.8 percent annually during this period. Part of this growth reflected what was happening in the mortgage market as a whole, and part of it was due to a pickup in market share. The biggest part of that gain in market share arose from the purchase of pools of mortgages that were held as investments, rather than securitized. The GSEs found their capital levels growing nicely as they profited each year from a combination of their powerful advantages and a benign mortgage market. They, and their investors, came to realize that the most effective way to employ the capital was to hold on to the mortgages. This employed the excess capital while still producing significantly higher returns on equity than investors could expect to earn elsewhere, due to the GSEs’ funding and capital cost advantages. Securitization was also profitable per unit of capital, but it put little capital to use.

Both the Bush administration and the Federal Reserve under Chairman Greenspan were quite concerned about the potential risk the GSEs posed to the taxpayers and the financial system if they ran into trouble. Their high growth rates, particularly in their investment portfolios, were viewed as a dangerous response to distortions produced by their excessively favorable structural benefits.

The administration therefore pushed for a stronger regulator, higher capital requirements, and limits on the size of the GSEs’ investment portfolios. Congress, however, blocked most of the serious reforms in these areas, although some steps were taken.

Ironically, the major fear of critics was that the mismanagement of interest rate risk would bring these giants down, when in fact the basic business of taking credit risk on mortgages was the proximate cause of their failure. The fear about interest rate risk management was considerably heightened when it became clear that there were significant accounting failures at both of the GSEs with regard to how they calculated their exposure to losses on their massive books of interest rate derivatives. In 2003 Freddie Mac had to acknowledge that investors should not rely on their financial statements, and Fannie Mae followed in 2004. It took approximately three years to create acceptable accounting systems that allowed newly issued financial statements to be certified as accurate. Thus critics may well have been correct about the dangers on the interest rate side, but they largely missed what turned out to be the bigger issue.

The bursting of the housing bubble and the ensuing severe financial crisis put the GSEs in an untenable position. Impending large credit losses started to raise some doubt in investors’ minds as to the seemingly risk-free nature of their debt, forcing the GSEs to pay higher and higher spreads and raising the prospect that a day might come when they would not be able to roll over their debt at
a reasonable interest rate. This had become particularly critical since the GSEs borrowed most of their funds on a relatively short-term basis, certainly much shorter than the long-term mortgage assets they held as investments. In the end, the federal government, primarily through the Treasury Department, had to step in to recapitalize the two mortgage giants, effectively making the implicit debt guarantee explicit going forward.

**Current Status of the GSEs**

The financial state of the GSEs, and the associated concerns in the financial markets about their solvency, reached a critical point in September 2008 that forced the federal government to intervene directly. A law had been passed in July 2008 establishing a mechanism that would allow the FHFA to take over a GSE under a “conservatorship.” The conservatorship would allow the GSE to continue operating, but under close government control. It would also give the FHFA the ability to determine which classes of investors would suffer financial losses, if any, much as the Federal Deposit Insurance Corporation is empowered to do for banks.

The FHFA used this authority on September 7, 2008, to put both GSEs into conservatorships. The Treasury stepped in the next day with an initial purchase of $1 billion of senior preferred stock in the two firms and a pledge to invest as much as $100 billion more, per firm, if needed to maintain positive net worth. (This cap was removed at the end of 2009 for capital needs through 2012.) This aid came with a high cost to the shareholders, since the Treasury received the right to buy 79.9 percent of the common shares of each of the firms for a few dollars.

The FHFA’s conservatorship effectively gave it the powers normally belonging to shareholders and the board of directors, in addition to its standard regulatory authority. The agency used those powers to remove some of the key managers and board members who were in charge when the GSEs failed.

Today, the federal government effectively owns the GSEs and exerts strategic control. In conjunction with this, the GSEs are being used more explicitly than ever as an arm of federal housing policy, although they are still theoretically non-governmental entities. For example, the GSEs are required to participate in two sets of foreclosure mitigation programs established under the Making Homes Affordable Program. Of one of these programs, Fannie Mae’s Form 10Q filing for the third quarter of 2009 stated that the program would “likely have a material adverse impact on our business, results of operations, and financial conditions, including our net worth.” The GSEs presumably would not have chosen to participate if they had been privately owned and operated entities.

6. I am indebted to Dwight Jaffee for pointing out this statement in the regulatory filings.
The federal government’s conservatorship and overall regulatory powers, combined with its effective ownership of 80 percent of the common and all of the senior preferred stock, give it the ability to direct the actions of the firms now and to determine their future shape and course. In practice, the government is allowing existing management to operate the firms as private sector companies, except where regulators or the Treasury deem there to be significant public policy considerations or concerns about the effects on the safety and soundness of the GSEs. For example, the GSEs have been required to participate in fairly generous mortgage foreclosure mitigation efforts.

In addition to their importance to the economy, the GSEs also represent a considerable threat to the federal budget. The Obama administration has projected cumulative total capital injections from the Treasury Department of $224 billion, at its peak. (The net loss to taxpayers would be somewhat lower, since the government would benefit from dividends minus government funding costs, plus any repayment of the capital injections that might occur.) Moreover, external analysts have projected that the loss could rise to as high as $400 billion, although most estimates run significantly lower. Whatever the figure turns out to be, it is almost certain to be substantial and to represent the government’s biggest loss on its emergency responses to the financial crisis.

The current legal situation is unstable. Conservatorships are not intended to be long-term arrangements, but rather to allow a continuation of normal operations while a stable solution is developed. Nor does it make policy sense for the government to own the GSEs on behalf of the taxpayers, but to treat them in certain measures as private entities, with minority shareholders.

Chapter Summaries with an Emphasis on Policy Recommendations

This section provides summaries of the five chapters, with particular emphasis on their policy recommendations.

In chapter 3, Pozen provides an overview of the issues relating to home mortgages, beginning with an analysis of the public policy goal of promoting homeownership, in order to assess whether and to what extent the federal government should favor this policy. He concludes that homeownership has various advantages for society as a whole, such as the much-cited research papers showing that people behave better (from society’s point of view) in multiple ways when they own a home. However, he also emphasizes the considerable damage to society that can result from booms that divert excessive resources to housing and

7. The regulators did require certain changes in management and the board, so current management is not entirely the same as the group that led the firms into trouble.
busts that destroy the finances and lives of many marginal owners of homes. He stresses that we need to be careful in designing government subsidies for homeownership. In addition, he states, most of the U.S. subsidies for homeownership are not very effective, and some of these subsidies increase the default rate on home mortgages—a key negative externality.

For example, the mortgage interest deduction is not well designed to promote homeownership and costs roughly $100 billion a year in lost tax revenues. To reduce the costs of the deduction and strengthen its link to homeownership, Congress should (a) eliminate the mortgage interest deduction for second homes and home equity loans and (b) provide a tax credit for mortgage interest on a primary residence or reduce the ceiling on the mortgage interest deduction from $1 million to $500,000 per couple. The second part of Pozen’s recommendation is intended to eliminate or mitigate the problem that the current tax treatment of mortgage interest heavily favors the better-off because they itemize their deductions, which is a requirement for receiving the benefit. They are also in higher tax brackets, increasing the value of each dollar of deductions; and they have larger mortgages on which to deduct the interest.

Pozen also cites the problems he believes are created by the “nonrecourse” nature of mortgages in many states. (Homeowners in those states can effectively eliminate their mortgage debt by handing the house keys back to the lender.) In almost all other countries, and the rest of the states in our country, lenders have the legal ability to pursue the borrowers for any loss taken on the sale of a foreclosed home. He believes that nonrecourse mortgages encourage homeowners to make excessively low down payments and to walk away from their mortgages if their house values drop too far. He suggests that Congress should (a) supersede state laws prohibiting personal recourse on mortgages and (b) allow individual hardship cases to be adjudicated by bankruptcy judges.

He believes that the FHA and VA perform valuable functions, but that they allow borrowers to make down payments that are too low—creating moral hazard and generally raising the risks in the system too far. In addition, Pozen believes that the benefits of these subsidized loans are not targeted sufficiently well toward low- and middle-income borrowers. Therefore, Congress should (a) gradually raise the down payment requirement for these programs to a reasonable percentage of the purchase price and (b) establish an income limit for these programs, such as the median income level for the metropolitan area.

Pozen proposes that Fannie Mae and Freddie Mac should be phased out gradually. Where there is an appropriate role for government support, it should be performed where possible by direct on-budget subsidies for housing or by an increased role for Ginnie Mae, FHA, and VA activities. The rest of housing finance should be performed through the private sector, including securitization of conventional mortgages. However, the Federal Reserve should provide...
liquidity to the mortgage securities market, if and when necessary, in order to mitigate the ill effects of housing busts.

He recognizes the need to revive the private market for mortgage-backed securities in order for his proposal to succeed and therefore proposes that federal regulators should (a) adjust capital requirements of bank sponsors of mortgage-backed securities to reflect the actual allocation of risk in these deals; (b) require more disclosure on the individual loans in the pools supporting mortgage-backed securities; (c) encourage simpler structures for such deals; and (d) minimize ratings shopping by allowing an independent party to choose the ratings agency for large structured finance deals.

Finally, Pozen addresses the question of how best to define qualified residential mortgages (QRMs), which he sees as “a middle tier of mortgage-backed securities, between the private tier and the government-subsidized tier.” (Dodd-Frank mandated that regulators define such a category of mortgages.) As he notes, since mortgage-backed securities based solely on QRMs would be exempt from risk retention requirements and certain other protections, regulators should mandate high down payments and strict underwriting standards for them. In addition, the criteria for QRMs should be designed to (a) phase out Fannie Mae and Freddie Mac by limiting the QRM status of their mortgages to a specific number of years; (b) promote long-term, fixed-rate mortgages by allowing prepayment penalties for the initial five years of high-quality mortgages; and (c) increase the standardization of home mortgages in the United States, including flexibility for mortgage servicers to modify loans in appropriate circumstances.

In chapter 4, Dynan and Gayer emphasize the importance of transitional arrangements in any housing finance overhaul, given that 88 percent of recent mortgages are backed by the government in some manner. However, they also emphasize the importance of making the decisions soon, even though there will be delays before all the changes are fully phased in. They fear that uncertainty about the future shape of housing finance could hold back the recovery of the housing market and the overall economy. Roughly the first half of their chapter is dedicated to explaining the current state of the housing market and reviewing the past and present role of the GSEs in housing finance.

The authors begin their policy recommendations with a strong critique of the fundamental structure of the GSEs. They state that the “conflation of the GSEs’ private and public goals is financially and fundamentally unsound. The implicit government backstop incentivized the GSEs to take on excessive risk. Because their debt was perceived as backed by the federal government, they were able to engage in a massive amount of arbitrage by borrowing at low rates and purchasing mortgage products with higher yields for their portfolios.” In addition, it is clear that “the future structure of mortgage finance should prevent the conflation
of public goals and private goals within any one entity. Any public goals for mortgage finance should be explicitly provided by the federal government.”

They go on to describe a second concern: “Another problem with the pre-crisis GSE model arose from how the two primary public goals of the agencies interacted with each other. The GSEs were to provide liquidity in mortgage markets by purchasing and securitizing mortgages and then selling them with a credit guarantee attached. And they were to promote affordable housing by subsidizing mortgages for low- and moderate-income families. As it turned out, the pairing of these two goals was a key factor behind the GSEs’ substantial credit losses.” In essence, the issue is that liquidity provision could be achieved at the lowest cost, and the least disturbance to the private market, by pricing the guarantees at an actuarially fair level. However, the promotion of affordable housing leads to pressures to subsidize the guarantees by charging premiums that are less than actuarially fair. And, indeed, this conflict appears to have contributed to the GSEs’ slide into insolvency. Further, the authors question the extent of the benefits of assigning an affordable housing mission to the GSEs: “The available evidence suggests that the GSEs—despite their affordable housing goals—have had only limited effects on the supply of affordable housing.”

These points lead the authors to make the following policy suggestions:

—Separate out the affordable housing mission. The entity offering the credit guarantee should not have an affordable housing mission and should charge actuarially fair prices. HUD could carry the affordable housing mission, “whether by expanding FHA programs or by providing direct, explicitly funded assistance to targeted borrowers.”

—Restrict portfolio holdings of the credit guarantor. To the extent that the GSE or credit guarantor has access to funds at better than a market rate, it should be restricted from holding large investment portfolios, since there would be too much temptation to arbitrage the difference between the government-supported borrowing rate and the market rate.

—Provide government-backed guarantees at actuarially fair, or higher, prices. The authors acknowledge that there are risks of “government failure” analogous to the risks of “market failure” that a government role would be designed to fix and that the former risks might even be larger than the latter. However, the market undoubtedly assumes a future and ongoing implicit guarantee. With this inevitable moral hazard in place, it is better to make the guarantee explicit, to contain it, and to attempt to price it accurately, rather than to leave an expansive and implicit guarantee that is more likely to be mispriced.

They go on to say that the market failure warrants a government role in insuring mortgage credit risk, but one that is sensitive to the risk of the sort of government failure described above. This can be achieved by limiting the government guarantee to easily priced, plain-vanilla, high-quality mortgages.
The authors acknowledge that offsetting increases may be needed in other affordable housing programs to make up for the decreased access created by raising the standards for mortgages eligible for government credit support. They also note that the market share of government-backed entities should decline, but view this as an upside, not a downside, of their proposal.

—Allow many securitizers, not just two GSE-like entities. The authors believe that the careful restrictions on the quality of mortgages eligible for government backing should make it possible to have a considerably more competitive securitization sector; therefore, they oppose the idea of having a small number of GSEs operating on a “public utility” model, whereby they are each carefully constrained, but essentially also privileged.

In chapter 5, Wallison argues, “Fannie and Freddie should be eliminated and not replaced because the U.S. housing finance system would function well without them, or any other government financial support, and the removal of any government role in housing finance would free the U.S. taxpayers from the costs of yet another massive bailout in the future. However, because of the central role of the GSEs in the current housing finance system, removing them from that system without a replacement is complicated and depends on factors that do not exist today.”

He then briefly surveys the role of government support to housing from the Great Depression through 2008, concluding that “two facts stand out” from his survey. “The government role in housing finance has been successful in standardizing mortgage terms and creating a national market for mortgages, largely through the sale and distribution of mortgage-backed securities. This has drawn financial resources from institutional investors in the United States and around the world, supplementing the funds previously supplied primarily by banks and by savings and loans. But these benefits have come at a huge cost to U.S. taxpayers, who have supplied in the past and will have to supply in the future hundreds of billions of dollars to bail out the losses incurred by government in its financial support for housing. In addition, once the government gets involved in assisting housing finance, its role will expand over time.”

He continues, “The massive government losses described above occurred because government agencies do not have either the incentives or the means to price accurately for the risks they are taking. Even if that were not true and the government could price for risk like an insurance company, political pressures would not allow a government agency to accumulate the reserves (as insurance companies do) during the good times that would be necessary to meet its obligations during the inevitable bad times.”

Wallison does not believe that providing the guarantees as backstops for securitizations would work any better than direct lending or guarantees of mortgages: “It is an illusion to believe that the government would be taking fewer
risks and suffering fewer losses if the government is only guaranteeing mortgage-backed securities.” Major moral hazard issues would arise because a government guarantee “will eliminate investor concern about both the quality of the underlying loans and the financial capacity of the issuer.” In fact, he believes, “Any continuing government support for housing finance is highly likely to result in massive taxpayer losses and thus, as a matter of policy, should be rejected as a valid policy path.”

Further, Wallison argues that better targeting of the benefits to those in greatest need is impossible in the long run, since “experience in the housing field shows that the benefits associated with government financial support cannot be effectively limited.” Political pressure will always cause a widening of the eligibility requirements. “Thus, once a government subsidy program is established, it will expand to cover larger and larger portions of the population and will drive out all competing private sector activity.”

He goes on to reject four arguments that he encounters in favor of continuing government involvement. First, he dismisses the argument that thirty-year, fixed-rate mortgages cannot exist without government support. He points out that even today a Google search turns up a large number of offers for thirty-year, fixed-rate jumbo mortgages, which are, by definition, not supported by Fannie and Freddie or another government body. Second, he does not see a valid reason why the housing industry, in preference to other industries, must be guaranteed a steady source of funds. In fact, he muses that government support for the steady availability of funds for housing finance may well have fueled housing bubbles in the past by eliminating some concerns about risk.

Wallison also rejects what he views as “probably the key reason for the support this idea enjoys in Washington,” which is that institutional investors might buy U.S. mortgages, or securities backed by those mortgages, only if they are supported by a government guarantee. He believes that high-quality mortgages will be attractive to institutional investors. “The key to a successful mortgage market is not providing a government guarantee—which will inevitably cause serious losses to the taxpayers—but ensuring that the mortgages made in the market are of prime quality.”

Finally, he believes that government backing is necessary to provide the concessionary rates or other benefits that will enable low-income families to become homeowners. He notes, however, that this objective can be achieved if government assistance is targeted to low-income home buyers and is not available to those who can participate in the prime market.

Wallison continues by asserting that the massive federal support for housing has not brought results remotely commensurate with the cost. He quotes a table developed by Dwight Jaffee to show that the U.S. housing system performs poorly when compared with other countries that provide much less government support.
He briefly reviews the housing market fluctuations of the last several decades and discusses why he believes that the recent housing bubble was so much worse than the others. He attributes this to a government-sponsored move to increase homeownership among low-income borrowers by reducing underwriting standards.

If the history of housing bubbles suggests that human nature fosters repeated and reinforcing market failures, what can be done? Wallison argues that regulation is necessary to assure that the bulk of mortgages in the system are of truly prime quality.

Steps to achieve this include requiring that all securitized mortgages meet certain underwriting standards, barring the use of nonprime loans as collateral for private mortgage-backed securities, covered bonds, and Federal Home Loan Bank advances. Rules for loans held in the portfolios of banks and other financial institutions could be looser, but full disclosure about the quality of loans in the portfolio is key. The last point, bringing more information to bear on the housing market, is relevant not only for the investor but also for the consumer. Something as simple as a one-page mortgage information form, signed early on when the home price is negotiated, would give the buyer a fuller understanding of potential costs under different scenarios.

Finally, countercyclical measures have a role to play in diluting the presence of weak mortgages. Mandating an increase in the down payment when home prices have risen by a certain amount could tamp down bubbles. And requiring countercyclical loan loss reserves during boom times could soften the impact of a crash, especially since banks are currently obligated to account only for expected losses.

Finally, Wallison concedes that it will take time to phase out the GSEs. First, a robust private securitization market needs to be restored, which he thinks will take perhaps two more years. He does not see delay as a practical issue, since Congress and the administration are unlikely to reach agreement on GSE reforms faster than that anyway. Second, he lays out a series of steps to provide a smooth phasing out of the GSEs over five years.

In chapter 6, Hancock and Passmore survey a history of failure in mortgage securitization and pose three questions:

1. Why is mortgage securitization fragile?
2. Would government provision of catastrophic insurance for mortgage credit likely improve financial stability?
3. Is there a potential role for Fannie Mae and Freddie Mac to provide government-backed insurance for mortgage-backed instruments?

To answer the first question, the authors analyze mortgage market equilibriums. They note that the liquidity that comes from securitization, irrespective of its effect on primary mortgage rates, creates the potential for a run. Investors who are sensitive to the presence of a guarantee will flee to safety if they doubt
The quality of mortgage-backed bonds and the associated guarantee, leaving only the highest-quality mortgages as a source of credit in times of stress. The results are tighter credit, greater declines in home prices, and weaker economic growth.

In answer to the second question, the authors argue that only the federal government, with its massive size and its power to tax, can credibly provide wide guarantees on a market as large as mortgage-backed securitizations. Private efforts to achieve the same result, including even the recent experience of the GSEs with their implicit government guarantee, are doomed to eventual failure. Private entities cannot credibly guarantee these obligations when confronted with the most severe crises of housing finance. Therefore, there will come a tipping point when the many investors who essentially relied on the guarantees, rather than on the quality of the underlying assets, will flee in a panic analogous to a bank run. This panic fuels itself and creates substantial disruptions in housing finance.

The authors propose that the federal government provide insurance for mortgage-backed securities, potentially including covered bonds, but only at a level of protection sufficient for catastrophes and not for more ordinary swings in housing markets. They fear that protecting against more ordinary events would create major moral hazard problems and lose many of the efficiency benefits of a solid private sector role in housing finance. They further propose that the government charge appropriate risk-based premiums for the protection.

To the third question, the authors also note that Fannie and Freddie could be used to provide the insurance, if they were appropriately structured, severely constrained, and given an explicit federal backstop. Such an approach involves relatively straightforward changes to the existing organizations, making it a feasible way to reestablish a robust private market for housing finance.

In chapter 7, Scharfstein and Sunderam begin with an economic analysis of the two main types of housing finance reform proposals: (a) maintaining government guarantees of mortgage-backed securities with adjustments to the past forms of guarantees and (b) privatizing mortgage markets by eliminating government guarantees altogether. Each type of proposal has strengths and weaknesses. On the one hand, guarantees are valuable during periods of great financial stress. On the other hand, they have limited benefits in normal periods; they may instead encourage moral hazard without substantially lowering mortgage rates. While private markets are capable of providing adequately priced mortgage credit in normal times, a wholly privatized market is prone to instability.

Their analysis of these two policy approaches leads the authors to believe that the purpose of housing finance policy should be fundamentally reoriented. Rather than trying to lower mortgage interest rates—especially when the tax code already incentivizes investment in housing—the main goals of housing finance policy should be to reduce volatility in the supply of housing credit and to prevent shocks to the housing sector.
With that new framework in mind, the authors propose a hybrid plan that draws from both approaches. First, Fannie Mae and Freddie Mac should be phased out to achieve a greater privatization of the market. Indeed, they argue that the main source of housing finance should be from the private market with no direct government guarantees. However, given the role of the private market in providing unstable and imprudent forms of housing finance—even at the peak of GSE involvement in subprime and Alt-A lending, the private market provided 70 percent of these types of loans—they argue that this market should be stringently regulated. Given the importance of securitization, they point to a variety of new approaches to ensuring some degree of safety in privately issued mortgage-backed securities, such as limits on the inclusion of risky mortgages and rules for the capital structures of securitization trusts. They go on to argue that no system of private finance can be foolproof and that a government-owned corporation could play a useful role as a guarantor of last resort during times of crisis. In their proposal, the government-owned corporation would “ensure the supply of high-quality, well-underwritten mortgages during a period of significant market stress” by guaranteeing newly issued mortgage-backed securities in such periods. The government corporation would not guarantee securities previously issued by private entities, but might need to have a small market presence as a guarantor during normal times to be able to ramp up its role quickly during a crisis.

In sum, their proposal seeks a well-regulated privatized mortgage finance market combined with a government agency that could serve as a backstop for new mortgage credit in times of crisis.

Key Policy Points

There is a surprising degree of consensus across the five chapters and between the authors and the Treasury white paper, despite the intense political and ideological struggles that have surrounded the GSEs in recent years. In particular, there is essentially no appetite to have the GSEs operate in something close to the manner in which they did in recent decades. For example, most of the proposals discussed here would abolish them or have their role taken over by the government; the rest would give them a much more circumscribed role, if they did survive. There also appears to be a complete consensus among this group that the affordable housing mission needs to be detached from the credit guarantee mission and moved to the FHA. The remainder of this section compares the views of the various chapters on key policy points.

Overall Role of the Federal Government in Supporting Housing

All of the chapters advocate a continuing federal role to support housing finance. Pozen is the most explicit in discussing the pros and cons, referencing the various
studies showing that homeownership encourages socially desirable behaviors. He views these benefits as worthy of federal support, but argues strongly for targeting subsidies to those households where the aid would make an appreciable difference in their ability to own a home rather than remain as renters. He suggests several changes to the current system of support, which he believes provides much more support to the relatively affluent than to those who would be able to support mortgage payments with some aid, but would otherwise be unable to afford a home.

Scharfstein and Sunderam include some modest discussion of broader housing policy goals, but focus very strongly on financial stability, arguing that the key objective should be “reduce excessive volatility in the supply of housing credit and protect the financial system from adverse shocks to the housing market.” They do not find convincing the arguments for providing a widely spread pricing subsidy, such as by undercharging for a government guarantee. They share Pozen’s concerns that such a subsidy encourages overinvestment in housing and essentially subsidizes existing homeowners, with little benefit for new home buyers, who face an offsetting increase in the price of the home they must purchase.

They also acknowledge the “significant benefits of meeting” the policy objective of encouraging housing affordability for low- and moderate-income households, while focusing on enhancing the safety of the housing finance system.

Dyman and Gayer implicitly take as given two existing policy goals: assuring the stability of housing finance and enhancing the affordability of housing for marginal home buyers. They address GSE reform as a better way to achieve these goals, without discussing whether these goals are justified. Presumably they would have addressed the desirability of these goals if they had disagreed with the consensus supporting those objectives.

Hancock and Passmore focus more narrowly on the stability of the housing finance system, but clearly believe that a federal role as a guarantor is necessary to assure that stability.

Wallison does not believe that federal support is necessary for housing finance as a general matter, either to encourage housing broadly or to assure stability beyond the normal role of regulating financial institutions. He leaves open, and seems implicitly to endorse, a federal role to assist low- and middle-income home buyers through a reformed FHA. However, he does not go so far in this chapter as to state explicitly that there should be such a federal mission.

In sum, there is a broad consensus among the authors that the federal government’s role in supporting housing finance was too broad and deep even before the housing crisis caused the government’s market share to skyrocket. They are all searching for a way to retain whatever government role is necessary to maintain the stability and smooth working of the housing finance market, while pulling back in those areas where the private sector can take over.
Role of the FHA

There is virtual unanimity among the authors that a housing affordability mission is appropriate and should be handled primarily through the FHA and not mingled with a credit guarantee mission, such as was the case with the GSEs. Pozen, Dynan and Gayer, and Wallison are all specific that there should be no mixing of those missions, a view also supported by the Treasury white paper. Scharfstein and Sunderam are less specific about the housing affordability mission, but seem to support both the existence of that mission and its clear separation from the credit guarantee role. Hancock and Passmore focus on a narrower question and do not seriously address this question.

Those authors who address the point are unanimous in calling for any federal subsidies to be accurately calculated and fully shown on the federal budget, in order to encourage the best decisions.

Importance of the Transition

There is also virtual unanimity that GSE reform must take several years, given the difficulties of the current housing market and the high proportion of new mortgages now guaranteed by the government, mostly through the GSEs. Wallison, along with Dynan and Gayer, puts the most emphasis on the transitional arrangements, but Pozen as well as Scharfstein and Sunderam also discuss the issue. Hancock and Passmore once again have a narrower, and somewhat more theoretical, focus that does not explicitly address this issue. The Treasury white paper also affirms the belief that a transition will take time and must be carefully designed.

Undesirability of Large Portfolio Holdings at a Government-Backed Credit Guarantor

Most of the chapters oppose the past practice of the GSEs (or some equivalent future private sector credit guarantor with government backing) of holding large portfolios of mortgages or mortgage-backed securities. Wallison underlines the dangers in this practice, Pozen calls for very significant limitations on it, and Dynan and Gayer agree that it should be limited, unless structural reforms create a competitive dynamic that sharply mitigates the risk to the public. Scharfstein and Sunderam, along with Hancock and Passmore, essentially avoid the issue by minimizing the extent to which government-backed private entities would be in the guarantee business. The Treasury white paper also calls for sharp cutbacks in the portfolio holdings of GSEs or their future equivalents.

Use of Actuarially Fair Pricing of Government-Backed Credit Guarantees

There appears to be unanimity that any direct or indirect federal guarantee of mortgages should be at actuarially fair, or higher, prices with the exception of
The Federal Role in Housing Finance

The affordable housing mission, which would generally be carried out separately by the FHA and similar entities. The partial exception to this statement is that Wallison does not want the government to do this at all, since he believes that it would be technically and politically difficult to achieve actuarially fair pricing, although he would favor such rates if the government had to be involved and could manage to charge at those levels.

The term “actuarially fair” leaves open the question about the extent to which taxpayers should receive compensation for taking risk, over and above covering the expected losses. Since guarantee fees would be charged in advance of the losses they would be expected to cover, it is necessary to bring the future losses back to a value in today’s dollars, using an interest rate known as a discount rate that represents the time value of money. If the discount rate for the actuarial calculation is a risk-free rate, then taxpayers would be paid nothing to compensate them for taking the risk that results are worse than expected. Scharfstein and Sunderam explicitly call for use of a risk-adjusted rate, whereas most of the other papers are silent on this important issue. (Fortunately, this issue is less critical for high-quality mortgage lending than for many other areas of finance, since the market assessment of the risk on these loans is not terribly far above U.S. Treasury rates. Nonetheless, the large dollar amounts involved do call for clarity on the ultimate decisions about how to price such guarantees.)

Existence of a Federal Credit Guarantor

The consensus breaks down on the question of whether the federal government should provide a credit guarantee for mortgage-backed securities, other than perhaps in support of a tightly focused housing affordability mission. Wallison clearly rejects this approach altogether. Pozen has a somewhat more nuanced approach, but essentially supports the elimination of government guarantees of securitization on private mortgage loans. Scharfstein and Sunderam strongly prefer a private market solution in normal times, but they want the government to be able to spring into a support role in crisis times and therefore see the need for a modest government role in normal times in order to maintain the capacity to ramp up in a crisis.

Dynan and Gayer support offering explicit federal guarantees of mortgage-backed securities, but at actuarially fair, or higher, prices. They believe that this would give the private market room to provide cheaper guarantees or learn to invest without credit guarantees, while maintaining the stability of the housing finance markets through a government backstop. However, this government backing would only be available for quite safe, standardized types of mortgages.

Hancock and Passmore take a similar approach to that of Dynan and Gayer, in that they recommend a government guarantee at actuarially fair prices, but only for super-safe mortgages. Essentially, the government would be there for
“catastrophic” credit risk, but would leave the normal run of credit losses for the private sector to bear. The underwriting criteria they suggest would therefore be considerably more strict even than those suggested by Dynan and Gayer.

The Treasury white paper leaves a range of potential options, making it difficult to compare the “Treasury view” directly with that of the authors.

At the risk of repetition, it is significant that none of the proposals offered in these papers would involve GSEs, or equivalents, nearly as large or as active as Fannie Mae and Freddie Mac were prior to the collapse of the housing bubble. The authors differ on the role of a federal guarantee, but all see the appropriate scale of that activity as much more restricted than how the GSEs operated.