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"Public Proposals for the Future of the Housing Finance System"

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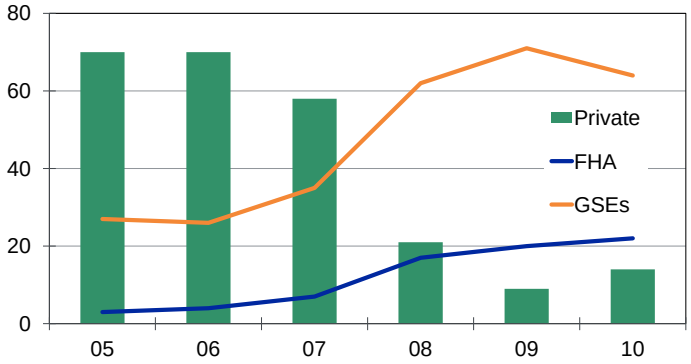
No one is comfortable with the federal government's current outsize role in the housing and mortgage markets. Nearly all of the first mortgage loans originated in 2010 were made by the federal government through the Federal Housing Authority, Fannie Mae, and Freddie Mac (see Chart). Acting on behalf of taxpayers, the FHA is taking on much more credit risk than was ever envisaged for this institution, and Fannie and Freddie are operating in conservatorship, a kind of regulatory purgatory. While changing any of this quickly would disrupt the still-fragile housing market and economy, none of it is sustainable in the long run.

Government Lending Filled the Void

% of total mortgage originations



Sources: FHA, GSEs, Moody's Analytics

This untenable situation is the result of the collapse of the private mortgage market during the financial panic. At its peak in 2005 in the midst of the housing bubble, the private market accounted for more than two-thirds of all originations. Powering private mortgage lending was securitization—the process of packaging mortgage loans into securities sold to global investors. Securitization was not new: The FHA, Fannie Mae and Freddie Mac had been securitizing mortgages for more than 25 years. But during the housing bubble, securitization surged in both size and scope, incorporating a wider range of mortgages, including subprime, Alt-A, and option-ARM loans. Securitization also grew more complex and opaque, so that even the most sophisticated investors had trouble evaluating the risks.

Critically, moreover, no participant in private mortgage securitizations had the responsibility for ensuring that the process worked. Mortgage banks and brokers originated loans but quickly sold them to investment banks, which packaged the loans into securities. Credit rating agencies assessed them, often using faulty information provided by the investment banks. Investors who purchased the securities took the ratings largely on faith. And government regulators provided little oversight, feeling the private market could regulate itself. Yet as the events of the past three years show, it clearly could not. Today, the private mortgage market is comatose.

Administration's proposal

The Obama administration in its recently released white paper appropriately argues that the government should phase out Fannie Mae and Freddie Mac and significantly scale back its role in the mortgage market—not quickly, but over time in a clearly defined way to allow the private market to revive.[i] A number of policy tools can help achieve this, including reducing conforming loan limits; raising insurance premiums and down payments on loans insured by the FHA, Fannie Mae and Freddie Mac; and requiring Fannie and Freddie to shrink their loan portfolios.

The administration proposes three potential options for the mortgage finance system as the government steps away:

- Option 1 would limit the FHA to a small part of the mortgage market, fully privatizing the rest of the market with neither explicit nor implicit government support.
- Option 2 would limit the FHA to a small part of the mortgage market in normal times, leaving the rest to private lenders, but would provide a mechanism, which the administration did not define, for the government to significantly expand its role if the private market falters.
- Option 3 would limit the FHA to a small part of the mortgage market in normal times, with private lenders making up the rest of the market, but the private market would be backstopped by explicitly priced catastrophic government insurance. The government would step in only after private investors were wiped out.

Hybrid system

Option 3 is similar to the hybrid private-public mortgage finance system Moody's Analytics has proposed, as have others, including the Housing Policy Council, the Mortgage Bankers Association, and the Center for American Progress.[ii] A hybrid system could take many forms, but the most attractive would retain several roles for the federal government—insuring the system against catastrophe, standardizing the securitization process, regulating the system, and providing whatever subsidies are deemed appropriate to disadvantaged households. Private markets would provide the bulk of the capital underpinning the system and originate and own the underlying mortgages and securities.

The government would provide catastrophic insurance on mortgage securities only after major losses, much as the FDIC insures bank deposits. The FDIC ended runs by scared depositors on U.S. banks during the Great Depression. Catastrophic mortgage securities insurance would eliminate runs by scared investors on the global financial system such as those in 2008, precipitating the Great Recession.

Catastrophic insurance would ensure that mortgage credit remains ample in the bad times, and—assuming it is properly priced—at no cost to taxpayers. It would also reduce the odds of bad lending in good times, since the insurance would be offered only to qualifying mortgages or to others only at a high price. Since private financial institutions would put up the system's capital, there would be significant incentive to lend prudently and, given the competition in a mostly private system, to innovate as well.

A hybrid system is superior to the other options for the future mortgage finance system, resulting in measurably lower mortgage rates, greater credit availability for more homeowners, and preservation of the popular 30-year fixed-rate mortgage. It also will compensate taxpayers for the risk of backstopping the mortgage finance system—a risk that will continue to exist no matter what choices lawmakers make for reform.

In a hybrid system, mortgage rates would be higher than they were before the housing crisis, but only because the previous system was undercapitalized. If the future system is capitalized sufficiently to withstand losses on defaulting mortgages that would result if house prices declined by say 25%—consistent with the price declines experienced in the current housing crash—mortgage rates would be approximately 30 basis points higher. Before the financial crisis, the mortgage finance system was capitalized to losses associated with a 10% decline in house prices.

Lower mortgage rates

But mortgage rates in the proposed hybrid system would be almost 90 basis points lower than under a fully privatized system. This is a significant difference. The monthly principal and interest paid by a typical borrower who has taken out a $200,000 loan for 30 years at a 6% interest rate is $1,199 under the hybrid system. With a 90-basis point premium in the privatized system, the monthly payment increases to $1,317, a difference of $118, or nearly 10%. The difference in payments under the two systems would likely be even greater for borrowers with less than stellar credit or who are seeking loans with higher loan-to-value ratios. The greater the risk, the greater the rate premium under the privatized system.

There are three fundamental reasons why mortgage rates will be lower in a hybrid system than they would be with full privatization:

Explicit pricing: Advocates of a privatized market presume that the government could credibly pledge never to intervene during a crisis. If private investors actually believed this, they would require larger returns on mortgage investments to protect against a catastrophic outcome. The cost of private mortgage insurance would therefore be higher.

On the other hand, if investors believe the government would bail out the market in a crisis, they will necessarily underprice the risk, leaving taxpayers exposed. History strongly suggests government would not allow the housing market to fail; no matter what lawmakers pledge today, investors know political winds change in times of economic stress. Taxpayers will be better off if the government explicitly acknowledges this likelihood and collects an insurance premium in exchange for its guarantees.

Standardization: Under the current mortgage system, Fannie Mae and Freddie Mac mortgage securities are highly liquid instruments, largely because they conform to strict guidelines. Investors in these securities pay for this standardization, which helps ensure a robust secondary market. Private-label mortgage securities are not standardized—a Wells Fargo security trades differently than one from Citibank or another issuer. Markets in these individual securities are thus much thinner, with wider bid-ask spreads.

Scale: Mortgage securitization has large fixed costs. Under a privatized system, each securitizer would bear the cost of operations, administration, reporting, auditing, etc. A single government-run securitization agency (a feature of most hybrid systems) would achieve economies of scale. The provision of insurance, including catastrophic risk insurance, also benefits from scale.

Standardization and scale are more likely with government coordination. Could industry participants come together to set tight standards on securities and achieve some economies of scale through clearinghouses? Possibly, but that hasn't happened so far. The American Securitization Forum, which issues guidelines, has little authority to audit or enforce them.

Preserving the fixed-rate mortgage

Homeowners would also benefit from the preservation of the popular 30-year fixed-rate mortgage, a type of loan that would quickly fade in a fully privatized system. The FHA introduced this type of mortgage after the Great Depression to forestall the mass foreclosures that occurred during that period. The current foreclosure crisis is a stark reminder of this benefit, as the bulk of recent foreclosures are on homeowners who had adjustable-rate mortgages.

Financial institutions have historically found it very difficult to manage the interest rate risk in such mortgages: As the cost of funds changes, the rate received from homeowners remains fixed. The savings & loan industry collapsed largely because of the mismanagement of this interest rate risk during the 1980s, and even Fannie and Freddie got into trouble using inappropriate interest-rate hedging techniques to manage their earnings in the early 2000s. It thus is not surprising that 30-year fixed-rate mortgages are very uncommon overseas, where the interest rate risk resides with lenders with no support from the government. Indeed, it is likely that a privatized U.S. market would come to resemble overseas markets, primarily offering adjustable-rate mortgages.

Other considerations

Taxpayer bailouts would also be unlikely in a hybrid system, as homeowners and private financial institutions would be required to put substantial capital in front of the government's guarantee, and there would be a mechanism to recover costs if necessary.

Given the fragile states of the U.S. housing market and economy, a transition from the current nationalized mortgage system to a hybrid system would take years and raise many issues, but these would be manageable. Given the expertise they have acquired over the past several decades, the downsized Fannie and Freddie could become federal catastrophic insurers. The transition would also involve establishing institutions and an infrastructure necessary to attract private capital.

One potential weakness of a hybrid system involves moral hazard: If private investors believe the government will bail them out if things go badly, they will take inappropriate risks. Moral hazard cannot be eliminated in a hybrid model, but it can be significantly mitigated. The system we support would require enough private capital to withstand massive losses—those associated with a 25% decline in house prices. The government's catastrophic insurance would kick in only if the losses were even greater, providing significant financial incentive for private investors to make sound lending decisions.

It is also important to recognize that moral hazard exists even in a fully privatized system. Investors in such a system are likely to assume that in extreme circumstances the government would still step in, congressional pledges to the contrary notwithstanding. Recent experience has only reinforced this belief, as the government stepped in during the financial crisis to bail out the system. In the hybrid system plan, the government's backstop is explicit and paid for by private investors.

Assertions that Wall Street banks and their associated financial institutions would fare better in a hybrid system than they would with full privatization are misplaced. In fact, Wall Street's profits would

likely be greater in a privatized system, which would be more fractured and less liquid, resulting in wider bid-ask spreads and thus bigger opportunities to profit from arbitrage. The need for ratings or other forms of credit analysis will also be much greater in a privatized system that is less standardized and not ultimately backed by the government.

Mortgage rates will be higher in the future than they were in the past and borrowers will face larger hurdles to obtain mortgage loans. Given the nation's fiscal challenges, the federal government cannot afford to continue large subsidies for homeownership. It is unclear that these subsidies were effective in any event, given the current foreclosure crisis. Nonetheless, it is critical that the mortgage finance system be better designed, or the costs for future prospective homeowners will be prohibitive, and the costs to taxpayers in the next financial crisis will be overwhelming. And if mortgage finance reform is done right, the American dream of homeownership will remain in reach for most.

[i] The Treasury white paper can be found at http://www.treasury.gov/initiatives/Documents/Reforming%20America%27s%20Housing%20Finance%20Market.pdf.

[ii] A detailed description and analysis of the Moody's Analytics proposal for a hybrid system is available at http://www.economy.com/mark-zandi/documents/Mortgage-Finance-Reform-020711.pdf.
.The Moody's proposal is similar to a number of other proposals; the most notable include a proposal by the Housing Policy Council of the Financial Services Roundtable (a group of 32 leading national mortgage finance companies) http://www.fsround.org/housing/gse.htm , the Mortgage Bankers Association http://www.mbaa.org/Advocacy/IssuePapers/CEML.htm , and the Center for American Progress http://www.americanprogress.org/issues/2011/01/pdf/responsiblemarketforhousingfinance.pdf