



Ten Arguments Against a Government Guarantee for Housing Finance

by Anthony Randazzo



Reason Foundation



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Part 1

Introduction

For decades, Fannie Mae and Freddie Mac have operated with an implicit guarantee from the federal government. Proponents of the government-sponsored enterprises (GSEs) argue that this guarantee allowed Fannie and Freddie to support the housing market before the crash and keep mortgage rates low. While there is debate over how much the subsidy for the GSEs actually did lower interest rates on mortgages, everyone agrees that the status quo, with the GSEs in conservatorship sustaining the housing market, cannot continue.

The question at hand is whether that implicit guarantee should become explicit in the new system or go away entirely. There is a growing belief among mortgage investors, industry groups and some policymakers in Washington that some type of explicit government guarantees for mortgage lending will be necessary to undergird a new housing finance system in America. This policy brief offers ten arguments for why this belief is misplaced and that there should be no government role—explicit or implicit—in guaranteeing housing finance.

Whether by the sale of insurance on mortgage-backed securities or a new public utility model, such a guarantee would be a tragic mistake, repeating the errors of history, and putting taxpayers and the housing industry itself at risk.

Part 2

Ten Arguments

1. Government guarantees always underprice risk.

The nature of any government guarantee is to underprice the risk it is guarding against. This is inherent in the goal of providing a subsidy through government intervention instead of relying solely on private sector guarantees. It is clear now that the government-sponsored enterprises failed to properly assess and price risk in the mortgage market over the past decades.

Unfortunately, the danger of underpricing risk has recently played out in front of our very own eyes as unexpected losses from subprime lending wound up spilling into the entire economy via the financial crisis. And this should bring pause to any supporters of a guarantee.

Federal Housing Finance Agency Acting Director Edward DeMarco testified in September 2010 that the presumption underlying support for a guarantee is that the market cannot evaluate and reasonably price the tail risk of mortgage default or cannot manage the volume of mortgage credit risk on its own. However, he went on to question if there is “reason to believe that the government will do better?” Furthermore, he warned, “If the government backstop is underpriced, taxpayers eventually may foot the bill again.”¹

Ultimately, the danger of underpricing mortgage-lending risks will lead to taxpayer losses again. Regulators may take high precaution now in pricing a government guarantee, but that does not ensure standards won’t break down in the future. A government guarantee may be particularly vulnerable to mispricing risk when credit losses are low and housing price appreciation is high.

While some may argue this is unlikely to happen, that same argument was pervasive over the past decades, and we have seen how that story ended. Underwriting standards were weakened and risk was misunderstood. Eventually, the American public will have to pay for underpriced risk.

2. Guarantees eventually create instability.

Not only did government guarantees fail to prevent the savings-and-loan (S&L) and subprime crises, they *contributed* to the financial turmoil that surrounded the collapse of both government-assisted business models. In less than three decades' time the S&L industry collapsed and toxic mortgage debt (subprime Alt-A and even prime) spread through the banking and financial industries. Peter Wallison writes that, "Both the S&L industry and Fannie Mae were the products of Depression-era legislation to assist the housing industry... Thus we have two business models, both operating in the housing field with government support, which eventually collapsed into insolvency with huge costs to taxpayers."²

What both the S&L industry in the 1980s and mortgage investors in the 2000s had in common was government backing, Wallison notes, and this is what led to the substantially reduced market discipline seen in both periods of housing finance. The guarantees allowed for rapid growth, but it was temporary. Furthermore, they encouraged extraordinary risks at the GSEs and private sector firms that destabilized the market and led to hundreds of billions in losses for the taxpayer.

3. Guarantees inflate housing prices by distorting the allocation of capital investments.

The aim of any government guarantee, whether implicit or explicit, is to encourage more mortgage lending than would otherwise take place without the subsidy for risk. This inherently means that resources would be redirected away from those investments that the market would otherwise determine to be their best use—such as medical technology, infrastructure, telecommunications, etc.—into housing finance.

This additional capital available to fund mortgages would mean increased lending to buy homes and less expensive mortgages. With cheaper and more readily available mortgages, an increasing number of people would be willing to spend more on homes, also driving up housing prices.

It sounds good, but unfortunately this is the exact phenomenon seen during the housing bubble: affordable housing goals led to decreased underwriting standards and a flood of money toward housing. But as those goals drove more money into housing, prices kept rising, forcing policymakers to increase their affordable housing subsidies.

In principle, it is not a problem for home prices to rise, or for investors to look for a good return in the housing market. However, if investment is being driven into the housing market through a government-guarantee-created subsidy, then the increased prices will be artificially inflated and eventually will come down. This will hurt buyers looking for affordable homes as the bubble grows, and sellers as inflated home values collapse. Investors with misplaced confidence in the stability of housing market growth will also see losses from defaults by putting their money in a subsidized market. In these ways government guarantees are inherently destabilizing for the housing market.

4. Guarantees degrade underwriting standards over time.

With a government guarantee, investors are not be liable for losses on mortgage defaults. Without a government guarantee lenders and investors are on the hook for any credit losses. The latter scenario understandably yields less financing for mortgages, as creditors more carefully consider where they put their money, and that bothers supporters of a government-subsidized market.

The problem is that with government guarantees, mortgages go to borrowers who otherwise wouldn't be considered creditworthy. For a guarantee to be effective, it must lower underwriting standards so that the additional credit beyond what a private market would offer has a place to go. This is what happened during the last bubble. Through HUD's affordable housing goals and rules for banks regulated by the Community Reinvestment Act (CRA), underwriting standards became so low that subprime loans, such as no-income no-job no-assets mortgages (or NINJA loans), became common place and were improperly sold as very safe "AAA" rated mortgage-backed securities.

According to Ed Pinto, former chief credit officer at Fannie Mae, by the middle of 2008 there were 27 million subprime and Alt-A mortgages in portfolios, securitized or guaranteed. The government was supporting 19.2 million, or about 71 percent, of these low-quality mortgages through the GSEs, FHA, CRA banks and others. Private-label mortgage-backed securities accounted for the remaining 7.8 million poor quality loans.³

Ultimately, well-intentioned policymakers who did not understand how they were destabilizing the market created this risky lending paradigm. But even the chastening of the financial crisis is unlikely to change the nature of politicians who will always want government subsidies to accomplish their public policy objectives or reward select constituencies. While underwriting standards may be high today, a guarantee would likely enable some type of affordable housing goals or homeownership rate targets in the future to once again influence the distribution of the extra mortgage credit such a subsidy brings into the market.

These goals are inherently destabilizing and would just lead to another bubble, eventually hurting those that the policymakers are trying to help, such as the low-income families struggling today as a result of previous affordable housing policy failures. Some have argued that "this time is different" and that politicians have learned. But this mantra has been a theme throughout history. As Ed DeMarco testified, lawmakers will always "want a say" about mortgage lending, but the potential distortion from this intervention "risks further taxpayer involvement if things do not work out as hoped."

5. Guarantees are not necessary to ensure capitalization of the housing market.

Defenders of government guarantees argue that without a subsidy, there will not be enough mortgage lending. The current residential housing market is capitalized by about \$11 trillion, and this number could be reduced if some investors didn't have taxpayer dollars protecting them against loss.

However, this argument ignores two important things. The first is investment in the jumbo market. With the so-called high cost-area conforming loan as high as \$729,750 today, most mortgages qualify for financing from Fannie and Freddie. Yet, the jumbo market still exists and has been returning to health. One sign of this is a return of capital for jumbo loan investment, specifically from Redwood Trust, which is on pace to issue over \$500 million in jumbo MBS by the end of 2011. Another sign is historically low jumbo fixed-rates that have been averaging roughly 5 percent. In fact, the price of jumbo loans is well below the average price for a conforming 30-year fixed-rate mortgage before the bubble crash. This indicates investor appetite exists for the more risky jumbo loans, even in this economy.

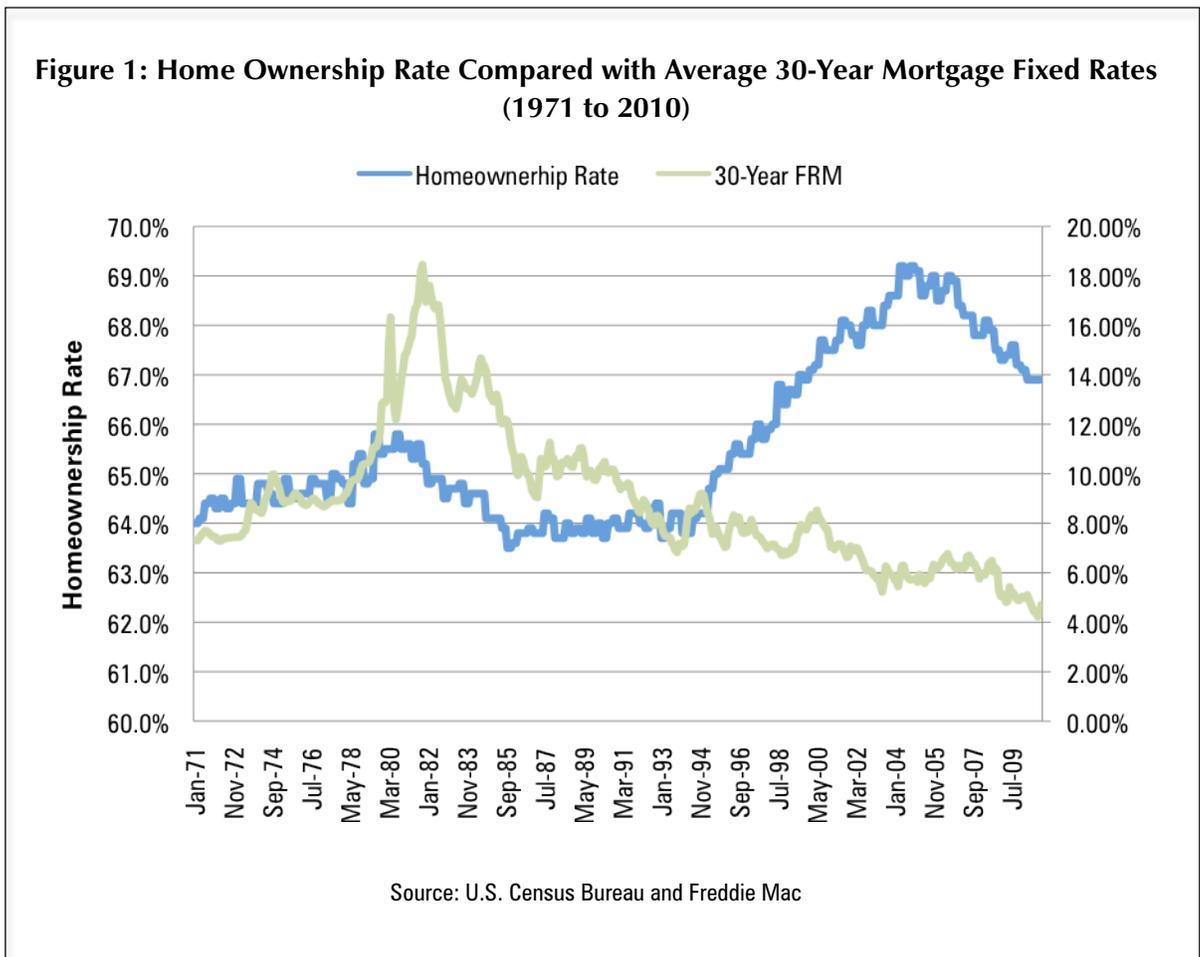
The second issue to note in countering arguments for guarantees is the arbitrary notion that \$11 trillion is the proper capitalization of the residential housing market. Without the subsidy, it is likely there would not have been as much lending for housing over the past few decades, but exactly how much less cannot be definitively known. Still, even if there was less lending for housing, this is not inherently problematic for homeowners or the market. Public policy should not favor homeownership over renting, and certainly should not promote lending to homebuyers who are not financially stable enough to own a home.

If a future homebuyer is a creditworthy borrower, and mortgage credit is the most productive use of lender's capital, then individuals will be able to get affordable mortgages in a fully private market. While investors in jumbo loans today would be unlikely to capitalize the entire residential housing market as it exists today, they would loan money to creditworthy borrowers, ensuring a stability that prevents market bubbles. The market might not be the same size that it is today, but the current market capitalization includes subsidized funds that are misallocated from use elsewhere in the economy.

As mortgage lending transitions from a subsidized market to one without government guarantees, investors who only want to loan with taxpayers covering their losses will exit the market. Credit will be shifted mainly to creditworthy, stable borrowers, and will cease being readily available for homebuyers who aren't financially ready to own a home.

6. Guarantees are not necessary for homeownership growth.

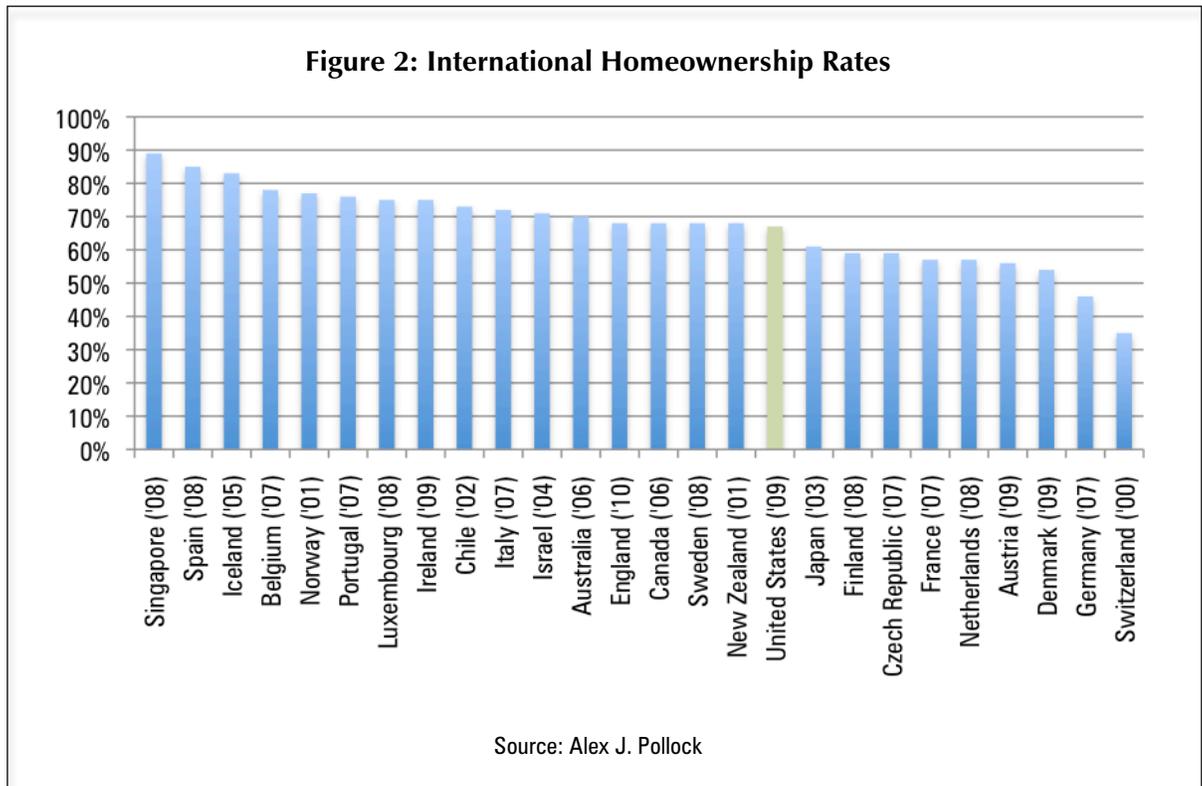
Many argue that guarantees are necessary to maintain growth in the homeownership rate, but this is unfounded on three fronts. First, there is no direct causation to be found between the artificially low interest rates caused by the implicit guarantee for Fannie Mae and Freddie Mac and the fluctuation of the homeownership rate. Looking at the past 40 years of 30-year fixed-rate mortgage data, there is barely any correlation between the value of a government guarantee and homeownership rates (see Figure 1).⁴



If the theory that higher mortgage rates would hurt homeownership were to hold true, then when mortgage rates rise homeownership should fall. However, both the homeownership rate and average rate on 30-year FRMs rose in the 1970s. Then, in the early 80s, homeownership began to decline while mortgage rates rose, as you might expect if there was causation. However, by the end of the 80s, mortgage rates had dropped back down to about where they were at the start of the decade, but the homeownership rate continued to fall.

More recently, it is clear that mortgage rates on the 30-year fixed-rate mortgage have been falling somewhat steadily since the mid-90s, starting at a 9 percent average down to today's sub-4 percent rate. However, the homeownership level shot up from 64 percent in 1995 to 69 percent in 2004 only to fall back down again to just above 67 percent in 2009.⁵

Second, while it could be argued that the government guarantee drove the residential market capitalization higher from the mid-1990s into the 2000s, this had the effect of creating the bubble—which in turn caused today’s massive foreclosure problem and decline in homeownership. At the same time, the United States is still ranked only 17th in homeownership among the top developed countries, according to former Federal Home Loan Bank of Chicago President Alex Pollock (see Figure 2).⁶



And other developed economies have been able to achieve much higher rates of homeownership without the same level of government intervention and entwinement.⁷ If policymakers want higher homeownership levels, there are more effective means than a sweeping guarantee for mortgage lending.

Third, using a taxpayer subsidy to allow people to become homeowners before they are financially able does not promote sustainable homeownership. The foreclosure mess today is a direct result of failed policies to boost the homeownership rate by fueling growth in affordable housing. In fact, at the end of the third quarter of 2010 roughly two out of every three mortgages at least 60 days delinquent was owned by Fannie or Freddie.⁸

7. Guarantees drive mortgage investment in unsafe markets.

The implicit government support of Fannie Mae and Freddie Mac meant investors in the GSEs and those paying for guarantees on their mortgage-backed securities did not have the incentives to do proper due diligence. The same phenomenon occurred during the build-up to the S&L crisis. As

long as there is a government guarantee covering financial institutions, investors and lenders will look to the government's credit, not the credit of institutions or of loan applicants themselves. This may ensure lending continues in a down market, but it also means that investors and lenders will be leaning on the taxpayers instead of ensuring they can stand on their own in the case of serious delinquencies.

Furthermore, the financial support of guarantees would help keep failing institutions operational long after they would have been declared insolvent with creditors stopping their investments had they been non guaranteed. This is exactly what was allowed to happen with Fannie and Freddie during the housing bubble, leading to significant taxpayer losses.

8. Guarantees are not necessary to preserve the TBA market.

A "To Be Announced" (TBA) market for mortgage-backed securities is an important part of housing finance because it allows originators and investors to use government guarantees to hedge against risk while mortgages are finalized, separated into pools, and fully securitized. Fannie Mae and Freddie Mac largely facilitate this market now, but a new market could easily develop for non-government guaranteed mortgages.

Currently, Fannie Mae and Freddie Mac issue some securities that don't detail the exact pooled mortgages until 48 hours prior to the established date the security is to be traded. These mortgage-backed securities are considered by some to be important to help provide mortgage liquidity, using the government to guarantee the mortgages will be added to the security at the agreed-upon date and encouraging more investors to buy securities.

However, government guarantees are not necessary to preserve the TBA market. Private mortgage lenders can announce their intention to sell a security, and then, over a short period of time between when mortgages intended to be added to the security are closed and sold, they hedge against the interest-rate risk present in the fixed-rate mortgages on their balance sheets or in warehouse lines. This allows the TBA market to develop, but only with lenders paying closer attention to how to manage their risks.

9. Guarantees are not needed to prevent "vicious circles" that drive down prices.

There are some who argue that without a government guarantee, lending will be restricted during market or economic downturns. Worse, the argument goes, is the threat of a "vicious circle" of price declines leading to decreased mortgage credit, further exacerbating falling prices, leading to defaults, leading to less credit from risk aversion in the credit market. But this entire scenario could only happen in a market already dependent on government guarantees and ignores the natural cyclical nature of housing.

There are always price swings in the housing market. These are necessary to keep balance in the market, as price declines help to sell off building inventories of homes, and price acceleration signals the need for increased resources so that supply can meet demand from homebuyers. Keeping prices artificially high reduces housing demand and prolongs recovery. Guarantees are not necessary to ensure mortgage investors will refrain from becoming risk-averse, since lenders are aware of the natural cycles in housing.

On the flip side, government guarantees are prone to ignoring the times when increased risk aversion is necessary to avoid continued lending in a troubled market. In fact, if there is a vicious circle of price declines and liquidity shortage in the future, the most likely culprits would be a government-guarantee-created housing price bubble.

Government guarantees also encourage more capital investments than is safe in housing. When price declines lead to a series of defaults, as happened in the wake of the previous bubble, it is most likely because the guarantee led to poor quality borrowers getting access to credit. The most common threat of default as prices decline is from borrowers who have little equity in their homes—because they borrowed at high loan-to-value ratios—seeing the value of their homes drop below what they owe. Guarantees support these high-credit-risk borrowers.

In a private market that requires sound underwriting standards this is unlikely to happen since homeowners would need to put at least 10 to 20 percent down at the time of purchase, meaning prices would have to fall dramatically to push them into negative equity default territory. And such large bubbles would be unlikely in a steady, stable growth environment promoted by private lending as opposed to a government guarantee juiced market.

10. Even a limited guarantee on only mortgage-backed securities to protect against tail risk will slowly distort credit and investment.

Several proposals for replacing Fannie Mae and Freddie Mac have suggested a government guarantee on mortgage-backed securities themselves, trying to avoid the moral hazard associated with directly supporting financial institutions. The idea is basically to provide a guarantee to protect against the tail risk of mortgage defaults—that is, to protect against an extreme scenario such as the recent subprime meltdown. However, even a limited guarantee that puts private capital in line to take first losses would have “shortcomings and inherent conflicts,” according to Edward DeMarco.

Such a system would still assume the government can properly price the guarantee, and does not address the inherent distortions with over-incentivizing capital in one sector of the market. A limited guarantee would just build a bubble slower, one that would still eventually need to unwind. In this way, even protecting against the tail risk is a self-fulfilling taxpayer bailout.

Part 3

Conclusion

While there may be a consensus forming that federal intervention and guarantees are necessities for the future of housing finance, the debate is far from over. Policymakers should beware arguments characterizing a government guarantee as vital or inevitable. Supporters of a guarantee should review their own research to look at the failures caused in the past by similar subsidies. The evidence is strong that guarantees do not preserve the housing market, but rather destabilize it, and are not even necessary to promote affordable housing.

Though some may argue that we have learned from the past and the new system will be different, remember that this is a constant refrain in the wake of crises, and the reforms after the S&L crisis failed to prevent the next meltdown. Even Presidential Advisor Paul Volcker notes that any explicit government guarantee of private mortgages will once again privatize profits and socialize the inevitable losses.

A huge amount of private capital is available to finance recovery and growth. There is no need for taxpayers to subsidize the future mortgage finance system and many reasons not to. The market can, and should, be left to fund American housing itself.

About the Author

Anthony Randazzo is director of economic research for Reason Foundation. He specializes in housing finance, financial services regulation and macroeconomic policy. Randazzo's work has been featured in *The Wall Street Journal*, *The Washington Times*, *The Detroit News*, *Chicago Sun-Times*, *Reason* magazine and various other online and print publications. He graduated from The King's College, in New York City with a B.A. in politics, philosophy and economics.

Related Studies

Rethinking Homeownership: A Framework for 21st Century Housing Finance Reform, by Anthony Randazzo

Letter to Treasury Regarding Housing Finance Reform, by Anthony Randazzo

What Caused the Meltdown: A Financial Crisis FAQ, by Anthony Randazzo and Carson Young

Endnotes

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 - ⁸ Mortgage Bankers Association quarterly delinquency data combined with quarterly reports from Federal National Mortgage Association and Federal Home Loan Mortgage Corporation.



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