BACK TO THE FUTURE: RETURNING TO PRIVATE-SECTOR RESIDENTIAL MORTGAGE FINANCE

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"The shapers of the American mortgage finance system hoped to achieve the security of government ownership, the integrity of local banking and the ingenuity of Wall Street. Instead they got the ingenuity of government, the security of local banking and the integrity of Wall Street."[1]

". . .[T]he GSEs play an extraordinarily successful double game. . .[telling] Congress and the news media, 'Don't worry, the government is not on the hook' – and then turn[ing] around and tell[ing] Wall Street, 'Don't worry, the government really is on the hook."[2]

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1. David Frum, *The Demise of Fannie and Freddie,* NATIONAL POST (July 11, 2008).

2. *Improving the Regulation of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks Before the S. Comm. on Banking, Housing, & Urban Affairs*, 108th Cong. i, iii (2004) (statement of Richard S. Carnell), http://www.banking.senate.gov/public/files/carnell.pdf.

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I.
INTRODUCTION[3]

Reforming the U.S. residential mortgage finance system remains the last, largely unaddressed task of financial regulatory reform in the wake of the financial crisis of 2008-2009. The summer of 2014 has marked the sixth anniversary of the insolvencies of Fannie Mae and Freddie Mac and the government conservatorships that continue to allow these government-sponsored enterprises (GSEs) to function. In a testament to the political difficulties of taking any action, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[4] was silent with respect to the fate of the GSEs, other than (in Section 1074) to mandate a study by the Department of the Treasury "on ending the conservatorship of Fannie Mae, Freddie Mac, and reforming the housing finance system."

The Obama Administration duly delivered that study to the Congress on February 11, 2011;[5] but, as a further testament to the political difficulties of taking action, the report simply outlined choices and did not indicate the Administration's position or preferences, let alone provide a specific proposal.

The 43 months that have elapsed since the release of that report have, unsurprisingly, yielded little in the way of concrete progress. Although various housing finance bills have

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3. This essay is a modification of the author's presentation at the NYU conference "The Future of Fannie and Freddie," which was held on September 20, 2013, and draws on and updates Lawrence J. White, *"The Way Forward: U.S. Residential Mortgage Finance in a Post-GSE World," in* HOUSE OF CARDS: REFORMING AMERICA'S HOUSING FINANCE SYSTEM. MERCATUS CENTER, GEORGE MASON UNIVERSITY, 67 (Satya Thallam ed., March 2012), *available at* http://mercatus.org/sites/default/files/House_of_Cards_March_2012.pdf. Like that article, this essay will focus on mortgage finance for single-family homes; multi-family housing finance is outside the scope of this essay.

4. 124 Stat. 1376, Pub. L. 111-203, codified at 12 U.S.C. § 5301 (2012).

5. *See* U.S. TREASURY AND U.S. DEP'T OF HOUS. AND URBAN DEVELOPMENT, REFORMING AMERICA'S HOUSING FINANCE MARKET: A REPORT TO CONGRESS (Feb. 2011), *available at* http://www.treasury.gov/initiatives/documents/reforming%20america's%20housing%20finance%20market.pdf.

been proposed in Congress, the prospect that any of them will be enacted into law before this Congress finishes its legislative session is vanishingly small. Perhaps the elections of November 2014 will clear the air and allow progress in the 2015-16 legislative session; perhaps not.

Until new housing finance policies are enacted, the status quo will prevail. This status quo involves approximately 90% of residential mortgage originations' being financed through government involvement as the federal government is directly and explicitly guaranteeing about 30-40% of all new residential mortgages through the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), and the U.S. Department of Agriculture (USDA). These guarantees are supplemented by the guarantees of Ginnie Mae, another federal agency that is lodged in the U.S. Department of Housing and Urban Development (HUD), when the FHA/VA/USDA guaranteed mortgages are securitized. Another 50-60% of new mortgages are being bought by the GSEs, which used to be described as having an "implicit" guarantee from the federal government, although the continuing conservatorships are making this guarantee increasingly explicit.

Although there is little consensus as to what the future structure of U.S. housing finance should be (which largely explains why little has happened since the inception of the GSE conservatorships of over six years ago), there is a general, though not complete, consensus that the status quo of predominant direct government involvement is not an acceptable long-run structure because of the general belief that the private sector should be the primary source of finance for housing and the primary bearer of the risks that are associated with that financing.

This brief essay will lay out the case for a largely private orientation for the future of residential mortgage finance. In an important sense, this description will approximate "option #1" of the Obama Administration's February 2011 report.

II.
THE APPROPRIATE GOALS FOR ECONOMIC POLICY, AND FOR RESIDENTIAL MORTGAGE FINANCE REFORM

Residential mortgage finance reform ought to be considered as part of "economic policy." The appropriate goals for

economic policy should be to pursue economic efficiency and to address market failures, which consist primarily of market power, externalities and spillovers, and asymmetric information.

In addressing market failures, of course, policy makers should be conscious of the limits of government – that there are government failures as well as market failures – and thus that market failures should be more than trivial before government programs are mobilized to attack them. Further, although economics has little to say directly about equitable distributions of income, economic policy is always enlisted in the political pursuit of equitable distributions. Embedded in this context, economic policy should endeavor to minimize the consequent efficiency distortions that inevitably accompany income redistribution efforts.

As a component of economic policy, the U.S. housing finance system should be reformed so that it embodies the true societal costs – the opportunity costs – of lending for home purchases. These costs encompass the fundamental time value of money, the costs of credit risk (i.e., the probability and costs of borrower non-repayment), the costs of interest rate risk, and the costs associated with mortgage illiquidity.

Any efforts to deal with the externalities that are related to housing, such as the positive externality from homeowners' greater likelihood of becoming involved in community issues, should be focused on addressing the externality.

Equally important is what a housing finance system should avoid: It should not function as a vehicle for income redistribution. Income redistribution is best accomplished through explicit programs that involve direct cash transfers rather than in-kind transfers and subsidies. Thus, an emphasis on "affordable" housing should not be part of the housing finance system. A housing system should also not function as a vehicle for maintaining residential property values, nor should it function as a vehicle for supporting employment in the home-building, real-estate, or mortgage-lending industries. Such efforts are recipes for the inefficient use of the government's scarce resources and for the support of entrenched interests.

III.
The Structure of a Privately Oriented Residential Finance System

There would be three components to a privately oriented residential finance system: a continued presence by FHA/VA/USDA (with securitization through Ginnie Mae) for first-time low- and moderate-income homebuyers; an expanded presence by depository institutions; and a revival of "private-label" securitization. Each will be discussed below.

A. *The Continued Presence of FHA/VA/USDA*

There is still a role for government in a privately oriented mortgage finance system. That role is to address the positive externality that appears to arise from home ownership: homeowners are more likely to become involved in local community affairs.

Addressing this externality calls for a modest-sized, on-budget program that specifically targets properly screened low- and moderate-income households that are on the cusp of buying a home rather than renting.[6] Household income and suitability for incurring a sizable debt load, rather than the size of the mortgage, should be the major criterion. Since the program would be intended to provide a subsidy, modest budgeted losses should be expected. Over the longer run, the current system of subsidizing the interest rate on the mortgage and allowing small percentage down payments, which encourages excessive borrowing and excessive leverage, should be replaced by cash subsidies, for instance through a system of matching funds, to help households increase their saving toward down payments.

6. This targeted program should not be seen as inconsistent with an overall approach to housing that reduces the emphasis on the importance of home ownership (e.g., by downplaying the idea that home ownership is part of "the American dream") and that makes renting a respectable alternative to ownership. In this vein, home ownership ought not to be portrayed as a "sure thing" profitable investment for households. Instead, a house should be seen primarily as providing "shelter" and as just another risky asset – albeit a large one – in a household's portfolio.

B. *Expanded Presence of Depository Institutions*

There is surely no returning to the world of the 1960s, when, for example, in 1965, depository institutions accounted for almost three-quarters of residential mortgages, and thrift institutions alone accounted for over 60%. However, as late as 2007, depository institutions held 30% of outstanding mortgage credit risk (i.e., their holdings of unsecuritized residential mortgage loans) despite the substantial advantages that the GSEs possessed in having lower borrowing costs (through the government's implicit guarantee) and lower capital requirements (as mandated by 1992 legislation[7]) for holding mortgages and for securitizing mortgages.

In a privately oriented mortgage finance system without the GSEs and their government-supported advantages, depository institutions would likely reclaim that 30% share and also fill some of the vacuum that would otherwise be created, thus expanding their holdings beyond 30%. This expansion could be helped modestly by a larger presence of covered bonds in the U.S.[8]

C. *A Revival of Private-Label Securitization*

The process of mortgage securitization, the pooling of large numbers of mortgages and the creation of tradable securities that are based on those pools, represents a powerful technology for the financing of home purchases. Unfortunately, that technology was badly abused by both the private sector and the GSEs.

7. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 106 Stat. 3941, Pub. L. 102-550, codified at 12 U.S.C. § 1456 (2012).

8. Covered bonds are debt instruments that are issued by financial institutions. These bonds represent a general claim on the financial institution, but also identify specific assets, usually residential mortgages, as the collateral security for the debt in the event that the general claim on the institution is deficient (e.g., in the event of the institution's bankruptcy). Equivalently, the lender to the institution has a claim on (recourse to) those assets in the event that the financial institution itself doesn't honor its obligation. Such covered bonds are prominent in some European housing finance systems, such as the German and Danish systems. In the U.S. financial system, repurchase agreements ("repos"), which are collateralized short-term lending arrangements between financial institutions, and collateralized advances (loans) from the Federal Home Loan Bank System to its member financial institutions have these characteristics.

Nevertheless, the potential value of the technology – in widening the sources of funding for residential mortgage finance, in allowing specialization in the vertically separated tasks that are the components of mortgage finance, and in allowing better allocations of risk among knowledgeable investors – remains. Private markets can be expected to learn from the mistakes of the past decade and revive a safer and more robust system of mortgage securitization. That system would rely on tighter underwriting standards for the mortgages that are the collateral for these securities, and on tranching to provide a class or classes of senior and relatively safe securities and a class or classes of riskier first-loss securities. However unlike in the past decade, the tranching structure is likely to be simpler and more transparent.

Insurance companies, especially life insurance companies, and pension funds would appear to be the natural buyers for the senior securities. After all, these are financial intermediaries that have long-lived obligations and ought to be interested in balancing those long-lived obligations with investments in the long-lived assets that the securitization of high-quality 30-year fixed-rate mortgages would provide.[9] These institutions are also not just "rate investors", who are simply seeking high but safe (i.e., with little or no credit risk) interest yields on their investments. As Table 1 *infra* indicates, a substantial percentage of these institutions' investments are in corporate bonds and even in corporate equities.

However, as Table 1 also reveals, these institutions have largely stayed away from mortgage-backed securities (MBS), even those that are guaranteed by Ginnie Mae and the GSEs.[10] One potential explanation is that the pre-payment "option" that is typically embedded in a 30-year fixed-rate mortgage (FRM) in the U.S., which means that the investment may not be as long-lived as the nominal 30-year term, has deterred greater investment. If so, then these institutions' demand for these securities would likely be encouraged by explicit prepayment fees by borrowers who choose to repay their mortgages prior to their contract dates.

9. The junior securities would likely be purchased by hedge funds and high-risk bond mutual funds.

10. Unfortunately, these institutions' holdings of any "private-label" MBS are not listed separately.

The participation of mortgage insurers, bond insurers, and the credit default swap (CDS) market will help spread the risks of the various tranches. And some depository institutions may find the liquidity and diversification of MBS to be an attractive alternative to holding the underlying mortgage loans instead.

D. *The Prerequisites for a Revival of Private-Sector Financing of Mortgages*

How do we get from here to there? The prerequisites are readily apparent. The GSEs must be phased out, through a combination of graduated reductions in the conforming loan limit (i.e. the maximum size mortgage loan that the GSEs can buy or securitize), increases in their guarantee fees, and a running down of their portfolios. So long as the GSEs remain fully operational, the private sector finance system will not be able to compete against them. Similarly, the FHA/VA/USDA mortgage loan limits (and thus the maximum size mortgage that can be securitized through Ginnie Mae) should be scaled back.

In addition, Dodd-Frank-derived regulatory uncertainties about mortgage securitization need to be resolved. Uncertainties with respect to the Mortgage Electronic Registration System (MERS) and its ability to achieve bankruptcy-remoteness for mortgage transfers also need to be resolved.

E. *What About the Viability of the 30-Year Fixed-Rate Mortgage?*

Many critics of a privately oriented mortgage finance system fear that the absence of widespread government guarantees would mean the demise of the 30-year FRM.[11] However, there is little connection between the going-forward viability of the FRM and the presence of government guarantees, since the latter cover only the credit risk on mortgages and not the interest-rate risk that is embodied in 30-year FRMs.

Further, as was discussed above, there are natural investors, such as insurance companies and pension funds, for the

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11. These fears seem to be based, at least partly, on the belief that, because the GSEs (with their implicit guarantee from the government) predominantly bought (and either held or securitized) 30-year FRMs, the FRM may not be able to survive without government involvement.

long-term obligations that the MBS that are based on 30-year FRMs would represent. These instruments would be even more attractive to these investors if there were pre-payment fees for borrowers who choose to pre-pay their mortgages.

Finally, it is worth remembering that 30-year FRMs for "jumbo" mortgages (i.e., those that are larger than can be bought or securitized by the GSEs or through Ginnie Mae) were available before the recent financial crisis and have continued to be available in recent years.

F. *What About the Affordability of Mortgages in a Privately Oriented System?*

A privately oriented mortgage system will involve mortgages that carry a higher interest rate than do government-guaranteed mortgages. That is an inherent and essential feature of having residential mortgages that fully reflect their opportunity costs.

However, the differential need not be large. Prior to mid-2007, the differential in interest rates between non-guaranteed jumbo mortgages and GSE conforming mortgages was approximately 25 basis points (0.25 percentage points). In a calmer economic and regulatory environment, this differential could well re-assert itself.

Finally, as argued above, the housing finance system should not be the vehicle for income redistribution and widespread subsidy.

G. *What About Government Regulation?*

There is an extensive role for government regulation: prudential regulation of systemically important financial institutions (SIFIs) that are directly or indirectly involved in mortgage finance; information regulation that can help with problems of asymmetric information; and consumer protection regulation to prevent abusive and discriminatory lending practices. The government may also be able to help private participants in the mortgage markets achieve the standardiza-

tion of mortgages and MBS that helps regularize transactions and thereby reduce costs.[12]

IV.
CONCLUSION

The resurrection of a privately oriented residential mortgage system is both a desirable and a feasible goal. Policymakers' primary task should be to clear the path so that this goal can be achieved.

12. However, along with standardization comes a reduction in variety and possibly even a greater rigidity and resistance to experimentation, which can make adapting to changed circumstances more difficult.

TABLE 1: SELECTED CATEGORIES OF FINANCIAL ASSETS THAT ARE HELD BY U.S. INSURANCE COMPANIES AND PENSION FUNDS

Third Quarter of 2013 (in $ billions)

Type of financial institution	Total financial assets[a]		Corporate and foreign bonds		Corporate equities		Mutual fund shares[b]		Agency- and GSE-backed securities	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Life insurance companies	$5855.6	100	$2186.2	37.3%	$1760.1	30.1%	175.9	3.0%	$364.6	6.2%
Property-casualty insurance companies	1489.2	100	384.7	25.8	280.0	18.8	14.4	1.0	115.1	7.7
Total insurance companies	**7344.8**	**100**	**2570.9**	**35.0**	**2040.1**	**27.8**	**190.3**	**2.6**	**479.7**	**6.5**
Private pension funds[c]	2789.9	100	327.4	11.7	1169.0	41.9	452.7	16.2	152.7	5.5
State and local government pension funds	3591.3	100	299.8	8.3	2307.1	64.2	279.5	7.8	217.3	6.1
Total pension funds[d]	**6381.2**	**100**	**627.2**	**9.8**	**3476.1**	**54.5**	**732.2**	**11.5**	**370.0**	**5.8**
Total insurance companies + pension funds	**$13,726.0**	**100**	**$3198.1**	**23.3%**	**$5516.2**	**40.2%**	**$922.5**	**6.7%**	**$849.7**	**6.2%**

[a] Excludes claims of defined benefit pension funds on their sponsors (i.e., unfunded liabilities).
[b] May include bond mutual funds and equity mutual funds.
[c] Defined benefit plans only; excludes defined contribution plans (e.g., 401(k) plans).
[d] Excludes U.S. Government retirement funds, since the defined benefit component is invested entirely in U.S. Treasury obligations.

Source:
BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: FLOW OF FUNDS, BALANCE SHEETS, AND INTEGRATED MACROECONOMIC ACCOUNTS Z.1 (Dec. 9, 2013), *available at* http://www.federalreserve.gov/releases/z1/current/z1.pdf.