No. 11-08
March 2011

WORKING PAPER

A NEW HOUSING FINANCE SYSTEM FOR THE UNITED STATES

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Implicit in most of the proposals for reforming the U.S. housing finance system is the idea that mortgage-backed securities (MBS) backed by U.S. mortgages cannot be sold unless they are issued by a government-sponsored enterprise (GSE), a U.S. government agency, or are otherwise guaranteed by the U.S. government. In this paper, I'll endeavor to show that continuing U.S. government involvement in the housing finance system will inevitably involve serious losses for the taxpayers, and that a U.S. housing finance system would function well without GSEs or any other form of government financial support simply by ensuring that the mortgages allowed entry into the securitization system are of good quality.

In order to demonstrate these points, it is necessary to consider the history of government financial support for housing, and the eventual costs of that government involvement.

U.S. GOVERNMENT FINANCIAL SUPPORT FOR HOUSING

The U.S. government's involvement with housing finance began in 1934 with the creation of the Federal Housing Administration (FHA), which had authority to insure mortgages up to 100 percent of the loan amount. At the time, there was no national market for mortgages, many local and regional differences in mortgage terms, very low loan-to-value (LTV) ratios of 50 to 60 percent, and a home ownership rate of less than 44 percent. Mortgages tended to be relatively short term, with bullet payments at the end. If a mortgage could not be refinanced at the end of its term—and many in the Depression could not be—it was foreclosed. The purpose of FHA was to overcome the reluctance of banks and others to make mortgage loans during this period. Over time, FHA had a major role in standardizing mortgage terms, increasing acceptable loan-to-value (LTV) ratios to approximately 80 percent, and encouraging the development of mortgages that amortized over multi-year periods.[1]

Although FHA could overcome the reluctance of lenders to make long-term mortgage loans, it could not provide them with the necessary liquidity. That role fell to Fannie Mae, which was originally chartered in 1938 to buy mortgages that had been FHA-insured. By purchasing these loans, Fannie Mae provided banks and other mortgage originators with the liquidity to make more mortgages and thus finance the growth of homeownership and the U.S. housing industry. By 1950, the homeownership rate in the United States had risen to 50 percent.[2]

S&Ls

During the Depression era, Congress also created the legal structure for a system of federal savings-and-loan associations (S&Ls), depository institutions that were limited to making loans for residential housing. Under a Federal Reserve rule known as Regulation Q, deposit interest rates had been capped since 1934. In 1966, in order to give the S&Ls an advantage over banks in competing for deposits—and thus to give a financial preference to housing—the Federal Reserve adjusted the cap so that S&Ls could pay one-quarter point more than banks for their deposits. The result was rapid growth in the S&L industry, which quadrupled in size between 1966 and 1979. When the rise of money-market mutual funds made it impossible for the federal government to continue to control deposit interest rates, Congress authorized the removal of deposit interest rate caps in the Monetary Control Act of 1980.[3] With the elimination of these rate restrictions,

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[1] Kerry D. Vandell, "FHA Restructiuring Proposals: Alternatives and Implications," *Fannie Mae Housing Policy Debate*, Volume 6, Issue 2, 1995

[2] Id.

[3] Depository Institutions Deregulation and Monetary Control Act of 1980, *Pub. L. No. 96-221; 94 Stat. 132), effective March 31, 1980*

S&Ls that were holding low interest rate 30-year mortgages became exposed to much higher market rates for their deposits and large portions of the industry became insolvent. The losses far exceeded the amount in the S&L insurance fund and the taxpayers eventually had to absorb a loss estimated at approximately $150 billion.

GSEs

In 1968, for budgetary reasons, Fannie Mae was "privatized" in the sense that it was allowed to sell its equity shares to the public. This removed it from the federal budget, but Fannie retained sufficient ties to the government—including a congressional charter and a "mission" to establish and maintain a secondary market in mortgages—that it became a quasi-public/private company known as a government-sponsored enterprise (GSE). In 1970, Congress also chartered an identical GSE, Freddie Mac, primarily to provide liquidity to the S&L industry in the way that Fannie was providing liquidity to banks, and authorized both GSEs to buy conventional mortgages in addition to those insured by the FHA or other government agencies. The congressional charters of both GSEs required that they purchase only mortgages that would be acceptable investments for institutional investors.[4]

In 1992, Congress enacted Title XIII of the Housing and Community Development Act of 1992[5] (the GSE Act), legislation intended to give low- and moderate-income borrowers better access to mortgage credit through Fannie Mae and Freddie Mac. The act authorized HUD to establish affordable housing goals for the GSEs. These goals, which were increased substantially during the Clinton and second Bush administrations, required that a certain percentage of all the loans that Fannie and Freddie bought had to be loans to borrowers at or below the median income in the area in which they lived. This put Fannie and Freddie in direct competition with FHA. Under the requirements of HUD's affordable housing goals, by 2008 Fannie and Freddie held the credit risk—either through mortgages they retained in their portfolios, or mortgages they securitized—12 million subprime and Alt-A loans. This was about 40 percent of their single-family book of business. At the same time, FHA had insured the credit risk for, and other government agencies held, about 5 million subprime and Alt-A loans. [6]

As a result of defaults on the subprime and other high-risk loans that they acquired under HUD's affordable housing requirements, Fannie and Freddie are now insolvent. Treasury has already contributed approximately $150 billion to cover their losses. Their regulator, the Federal Housing Finance Agency (FHFA), has projected that they will eventually require between $221 billion and $363 billion in government support. This may be optimistic, and depends heavily on the direction of housing prices in the years ahead.

FHA

By the late 1970s, the role of FHA had changed. Competition from the GSEs and private mortgage insurers had pushed FHA out of the business of insuring middle class mortgages; with the support of Congress, it began to concentrate increasingly on low-income borrowers, and to see its role as an element of the government's social rather than economic policy. During the 1960s and 1970s, to meet its social responsibilities, it had significantly increased the LTVs of the mortgages it would insure and otherwise lowered its underwriting standards. Although this increased its credit risks, its losses were low because of the secular growth of housing values during this period. During the 1970s' stagflation period, however, and in the regional recessions of the 1980s, substantial losses began to show up at FHA, requiring it to adopt tighter underwriting standards.

Still, as the government's authorized subprime lender, FHA seems to believe that it has an obligation to accept significant losses in pursuit of its mandate. Its claim rate has been excessive for many decades. Over a 35-year period (1975–2009), the agency's cumulative claim rate averaged 10.5 percent, and over 1992–2009 it averaged 10 percent. During the boom

[4] Section 1719 of Fannie's charter stated: "[T]he operations of the corporation…shall be confined…to mortgages which are deemed by the corporation to be of such quality, type, and class as to meet, generally, the *purchase standards imposed by private institutional mortgage investors*." [emphasis added]

[5] Public Law 102-550, 106 Stat. 3672, H.R. 5334, enacted October 28, 1992

[6] See Edward Pinto, "Sizing Total Federal Government and Federal Agency Contributions to Subprime and Alt-A Loans in U.S. First Mortgage Market as of 6.30.08," http://www.aei.org/docLib/PintoFCICTriggersMemo.pdf

years of 1995–2003, the claim rate still averaged nearly 8 percent, while during bust periods (1980–85 and 2005–2008), it averaged 18 percent. For 2010–17, the FHA has projected an 8 percent average claim rate even with an expected 33 percent increase in home prices over 2011–20.[7] Although the FHA's accounting is difficult to penetrate, and the agency claims that its losses are fully covered by the fees it charges for its insurance, a recent study by Barclays Capital suggests that the imbedded losses at FHA are substantial: "[W]e project cumulative default rates in the 20 percent area on average, with loss given default rates of 60 percent. This represents average losses of about 12pts, of which 8.5pts could flow back to taxpayers. On an original balance of $1.4trn, this translates to $130bn."[8]

By the 1980s, the operations of both FHA and the GSEs had created the beginnings of a national market—even an international market—in mortgages. Terms had been standardized, and the technology of securitization had been sufficiently developed so that it was possible for many kinds of institutional investors—insurance companies, pension funds, and mutual funds as well as banks and other depositories—to hold conventional mortgages or mortgage-backed securities. In addition, Fannie and Freddie, which were perceived in the market as having the implicit backing of the U.S. government, provided an important bridge between mortgage originators and the ultimate investors by placing their guarantee on the securities that were backed by pools of mortgages (mortgage-backed securities, or MBS). This eliminated the credit risk for these investors and facilitated the sale of the GSEs' MBS.

At the same time, following their charter requirements,[9] Fannie and Freddie established underwriting standards for downpayments, debt-to-income ratios, borrower information, and mortgage quality that limited their risks and kept delinquencies and defaults at very low levels. However, the existence of the GSE guarantee created moral hazard, in which neither investors in the GSEs' MBS nor the buyers of their debt securities cared about the quality of the loans they were buying, and as we will see this allowed Fannie and Freddie—responding to government requirements—to acquire vast numbers of subprime and Alt-A loans that were eventually the source of their downfall.

Finally, in the Housing and Economic Recovery Act of 2008, which toughened the regulation of Fannie and Freddie, Congress also increased the conforming loan limit for the GSEs in areas with high housing costs. The new limits in high-cost areas had the effect of increasing the size of the mortgages that Fannie and Freddie could purchase, so that buyers of homes in the million dollar range could have access to the benefits conferred by eligibility for purchase by the GSEs.

From this brief survey, two facts stand out. 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 MBS. This has drawn financial resources from institutional investors in the U.S. and around the world, importantly supplementing the funds previously supplied primarily by banks and S&Ls. But these benefits have come at a huge cost to U.S. taxpayers, who have in the past and will in the future have to supply 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 expands over time.

DEFICIENCIES OF GOVERNMENT FINANCIAL SUPPORT FOR HOUSING

These massive government losses occurred because government agencies do not have either the incentives or the means accurately to price 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 will 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. This has been shown not only by the experience of FHA but by similar experience of the FDIC,[10] the National Flood Insurance

[7] FHA Actuarial Studies for 2010 and 2000.

[8] Barclays, "US Housing Finance: No Silver Bullet," P.6

[9] The charters of Fannie and Freddie initially required them to buy only loans "that would be acceptable to institutional investors."

[10] When the deposit insurance system was reformed in 1991 in response to the failure of the FSLIC, Congress placed a limit on the size of the deposit insurance fund that the FDIC could accumulate to meet the demands of a future crisis. Since 1996, the FDIC has been prohibited by law from charging premiums to well-capitalized and stable institutions. As a result, between 1996 and 2006, institutions representing 98 percent of deposits paid no deposit insurance premiums.

program,[11] and the Pension Benefit Guarantee Corporation.[12] As a result, virtually every government intervention in the housing finance market has resulted in substantial losses for the taxpayers.

Many of the proposals making the rounds in Washington today rely on government guarantees of MBS issued by special companies formed for the purpose of securitizing mortgages. These are an obvious attempt to avoid the mistake of extending a government guarantee—implicit or explicit—to specific entities such as Fannie Mae and Freddie Mac. However, the Obama administration's plan, issued on February 11, 2011, upset the expectation of many that it would adopt or develop a plan for government backing of MBS as a replacement for Fannie and Freddie. Instead, the administration offered three options, one of which was a fully private-sector mortgage-financing system, with a separate on-budget government program for assisting low-income homebuyers. Another option was the expected proposal for government backing of MBS issued by private sector firms; the government's obligation would accrue only after the capital of the issuer was wiped out. A third option was a private sector system with a standby government backstop in case of a financial crisis.

Although it is difficult to assess the reasons for the administration's acceptance of the private-sector financing idea, there were suggestions in the white paper issued by the administration that they recognize the danger to taxpayers implicit in any government guarantee program, including one that would guarantee only MBS. This would be true because a government guarantee will create moral hazard by eliminating investor concern about both the quality of the underlying loans and the financial capacity of the issuer; the buyers of the MBS will not be concerned about either the quality of the underlying mortgages or the financial condition of the issuers of the MBS. The government, in turn, to protect itself and the taxpayers, will have to rely on regulation of the issuing firm, so that the issuer does not take excessive risk. As we have seen again and again, regulation has not worked to keep insured banks or the GSEs from taking risks, and there is no reason to believe that it will prevent the issuers of the MBS from doing the same. Accordingly, 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 sensible policy path.

Another reason for rejecting a government program, not mentioned in the administration's white paper, is that government support for housing cannot be effectively limited. Government support is a subsidy from the taxpayers to the buyers and sellers of homes, no matter where in the process the government support is injected, and as such confers a benefit on all homebuyers who are eligible to receive it. Accordingly, it is difficult—and probably impossible over the long term—to limit the availability of this benefit. No matter where the line is drawn, there is always a group that is excluded. This inevitably produces political pressure to provide excluded groups with access to the benefits of the government support. Because these groups are always more organized than the taxpayers, they are eventually able gain support in Congress for inclusion within the eligible category. Thus, in 1992, Congress adopted affordable housing requirements for Fannie and Freddie, so that low-income and other borrowers who could not meet traditional mortgage standards would have access to

When the financial crisis hit in 2008, the FDIC's insurance fund was inadequate to meet the losses incurred by the FDIC. In 2009, FDIC chair Sheila Bair observed: "An important lesson going forward is we need to be building up these funds in good times so you can draw down upon them in bad times."[10] Instead, once the bad times hit, the FDIC was forced to raise its premiums at the worst possible moment, thereby reinforcing the impact of the down cycle. Principle II will discuss in greater detail the need for countercyclical reserving policies. Center on Federal Financial Institutions, "Federal Deposit Insurance Corporation," August 10, 2005, www.coffi.org/pubs/Summaries/FDIC%20Summary.pdf (accessed January 14, 2011). See also Congressional Budget Office, "Modifying Federal Deposit Insurance," May 9, 2005, "Currently, 93 percent of FDIC-insured institutions, which hold 98 percent of insured deposits, pay nothing for deposit insurance."

11 "FEMA Administrator Craig Fugate says the debt results partly from Congress restraining insurance rates to encourage the purchase of coverage, which is required for property owners with a federally backed mortgage…. 'It is not run as a business,' Fugate said. Congress' Government Accountability Office said in April that the program is 'by design, not actuarially sound' because it has no cash reserves to pay for catastrophes such as Katrina and sets rates that 'do not reflect actual flood risk.' Raising insurance rates or limiting coverage is hard. 'The board of directors of this program is Congress,' Fugate said. 'They are very responsive to individuals who are being adversely affected.'" (Thomas Fink, "Huge Losses Put Federal Flood Insurance Plan in the Red," *USA Today*, August 26, 2010.

12 As of the end of FY2010, the Pension Benefit Guaranty Corporation (PBGC) reported a deficit of $23 billion. "In part, it is a result of the fact that the premiums PBGC charges are insufficient to pay for all the benefits that PBGC insures, and other factors." Pension Benefit Guaranty Corporation, "2010 PBGC Annual Report," www.pbgc.gov/about/ar2010.html (accessed January 14, 2011).

the benefits that the GSEs conferred on the middle class. Similarly, in 2008, in the Housing and Economic Recovery Act (HERA),[13] Congress conferred the same benefits on high income constituents by increasing the conforming loan limits of the GSEs so that they could buy mortgages on million dollar homes in areas where housing prices were especially high.

Thus, once a government subsidy program is established, it will expand to cover larger and larger portions of the population, and drive out all competing private-sector activity, just as Fannie and Freddie drove all private competition out of the areas of the housing market where they were allowed to operate.

ARGUMENTS IN SUPPORT OF GOVERNMENT INVOLVEMENT

Judging by the proposals that are circulating today in Washington, there is still a great deal of support for some continuing role for Fannie and Freddie or for a new system in which the government will still be responsible for backing some portion of the housing finance market. Given the deficiencies and taxpayer losses associated with past government efforts, what are the arguments that are advanced to support yet another government financial support program for housing?

The easiest of these arguments to dismiss is the one most often cited—that government backing is necessary to assure that a 30-year fixed-rate mortgage is available for homebuyers. This one is simply a myth. Jumbo fixed-rate 30-year mortgages, which by definition are not government backed, are freely available and advertized extensively on the Internet. A Google search for "Jumbo 30 year fixed rate mortgage" turns up a host of offers. They might be somewhat more expensive than a government-backed 30-year fixed-rate mortgage, but that's only true because the taxpayers are subsidizing the government-backed version. Why it makes sense for the taxpayers to subsidize a mortgage that people can freely get without taxpayer assistance, is a puzzle, particularly when that particular mortgage does not make much sense as a matter of public policy. It amortizes very slowly, so it doesn't create much equity in a home for many years (on average Americans change residences every seven years), and at a time when we are finally recognizing the problems associated with excessive leverage in home ownership the 30-year fixed-rate mortgage encourages maximum homeowner leverage.

Another argument is that the mortgage market must be assured of a steady flow of funds; otherwise, the process of building homes will be slowed or interrupted for periods when mortgage money isn't readily available. One has to wonder why the housing business deserves to be protected against changes in the availability of funds, when every other industry has to live with this cyclical problem. Moreover, the fact that housing finance has been protected all these years against the fluctuations that every other industry has to bear probably has something to do with the bubbles to which this industry seems particularly prone. Concern about the availability of funds is likely to reduce risk-taking and speculation, and that's something that as a matter of policy we ought to encourage.

A third argument—sometimes explicit and otherwise implicit—is that institutional investors will only buy U.S. mortgages, or MBS backed by U.S. mortgages, if they are supported by a government guarantee. This is probably the key reason for the support this idea enjoys in Washington, and it would certainly be true if the quality of the mortgages is low. But as discussed below there is no reason why mortgages allowed into the securitization system should be of low quality. Until the introduction of the affordable housing requirements for Fannie and Freddie, the GSEs maintained high underwriting standards and never suffered substantial losses on the mortgages they held or guaranteed. Even in the current crisis, their delinquency rates among *prime* mortgages have been less than 3 percent, while their delinquency rates on the subprime and Alt-A loans they acquired because of the affordable housing goals have ranged from 13.3 to 17.3 percent.[14] Accordingly, the key to a successful mortgage market is not a government guarantee—which will inevitably cause serious losses to the taxpayers—but ensuring that the mortgages that are made in the market are of prime quality.

Finally, the argument is made that only with government backing can we provide the concessionary rates or other benefits that will enable low-income families to become homeowners. This is true, but it does not mean that the entire housing market has to be government backed—only the portion that is targeted to low-income homebuyers.

[13] Public Law 110–289—JULY 30, 2008

[14] Pinto, "Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study," November 4, 2010, chart 53, http://www.aei.org/docLib/Government-Housing-Policies-Financial-Crisis-Pinto-102110.pdf.

WEIGHING THE POLICY ARGUMENTS FOR AND AGAINST GOVERNMENT BACKING

If we weigh taxpayer losses in the balance, the policy arguments in favor of government involvement in housing finance seem weak indeed. Over the nearly 70 years that the government has been attempting to assist housing finance, the taxpayers have been called upon to rescue one or another specially designed government program every time, and the costs—by the time the GSEs' and FHA's losses have been added up—will have run into the hundreds of billions of dollars. We did get a nationwide mortgage market, a standardized mortgage, and an efficient system for turning a mortgage into a suitable and liquid investment for an institutional investor, but the costs for the taxpayer have been horrific.

In other important areas, government involvement in the housing finance system has also been a failure. First, as shown in the following table prepared by Dwight Jaffee, the U.S. ranks last among a number of developed countries in terms of the average interest rate on residential mortgages. This is remarkable, considering that in most other developed countries there is no direct government backing of mortgages. Moreover, government financial backing has not succeeded in raising the U.S. homeownership rate over the long term. This rate reached 64 percent in 1964, and remained there for 30 years. The rate began to climb when Fannie and Freddie were making subprime and Alt-A loans under the affordable housing requirements imposed by Congress and administered by HUD, but since the insolvency of the GSEs (because of those very loans), and their inability to sustain affordable housing lending, U.S. home ownership rates seem to be returning to the historic rate of 64 percent. When considered among a large number of developed countries, the United States ranks 17th in homeownership,[15] and among Professor Jaffee's list of countries it ranks 9th. In other words, U.S. taxpayers have received very little for the huge costs they have borne. The following table, prepared by Dwight Jaffee, shows the position of the U.S. on key housing issues among a number of other developed countries.

[15] *Testimony of Alex J. Pollock, Subcommittee on Security and International Trade and Finance, U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Cong. (September 29, 2010).

TABLE 1: THE PERFORMANCE OF EUROPEAN MORTGAGE MARKETS IN COMPARISON WITH THE U.S. MARKETS *

(Statistical measures computed with annual data by country for 1998–2008)

	(1)	(2)	(3)	(4)	(5)	(6)
	Mortgage to GDP Ratio	Rate of Owner Occupancy	Coefficient of Covariation Housing Starts	Standard Deviation of House Price Inflation	Mortgage Interest Rate Average Level	Mortgage Interest Rate Average Spread **
	2008	2008				
Western Europe						
Austria	25.3%	57.0%	8.3%	2.6%	5.12%	0.66%
Belgium	39.8%	78.0%	16.3%	4.0%	5.87%	1.37%
Denmark	95.3%	54.0%	40.8%	6.1%	5.96%	1.41%
Finland	47.5%	59.0%	11.0%	3.4%	4.5%	0.05%
France	35.9%	57.4%	16.4%	5.5%	4.93%	0.53%
Germany	46.1%	43.2%	30.1%	0.8%	5.27%	0.97%
Iceland	129.0%	82.5%	56.3%	9.8%	5.01%	0.64%
Ireland	80.0%	74.5%	35.8%	11.5%	4.69%	0.22%
Italy	19.8%	80.0%	47.0%	3.1%	5.25%	0.64%
Luxembourg	43.5%	75.0%	19.2%	4.3%	4.33%	–0.16%
Netherlands	99.1%	57.0%	10.2%	5.5%	5.17%	0.77%
Norway	55.7%	77.0%	21.1%	5.0%	6.54%	1.61%
Portugal	63.3%	76.0%	31.5%	5.4%	5.15%	0.61%
Spain	62.0%	84.5%	32.5%	2.5%	4.38%	–0.09%
Sweden	60.6%	52.0%	53.9%	5.1%	4.05%	–0.49%
UK	80.5%	59.0%	10.5%	5.0%	5.32%	0.42%
Euro Average	**61.5%**	**66.6%**	**27.6%**	**5.0%**	**5.10%**	**0.57%**
US Average	**83.6%**	**67.8%**	**24.9%**	**5.5%**	**6.57%**	**1.82%**
US Rank	**4th of 17**	**9th of 17**	**9th of 17**	**4th of 17**	**1st of 17**	**1st of 17**

Notes:

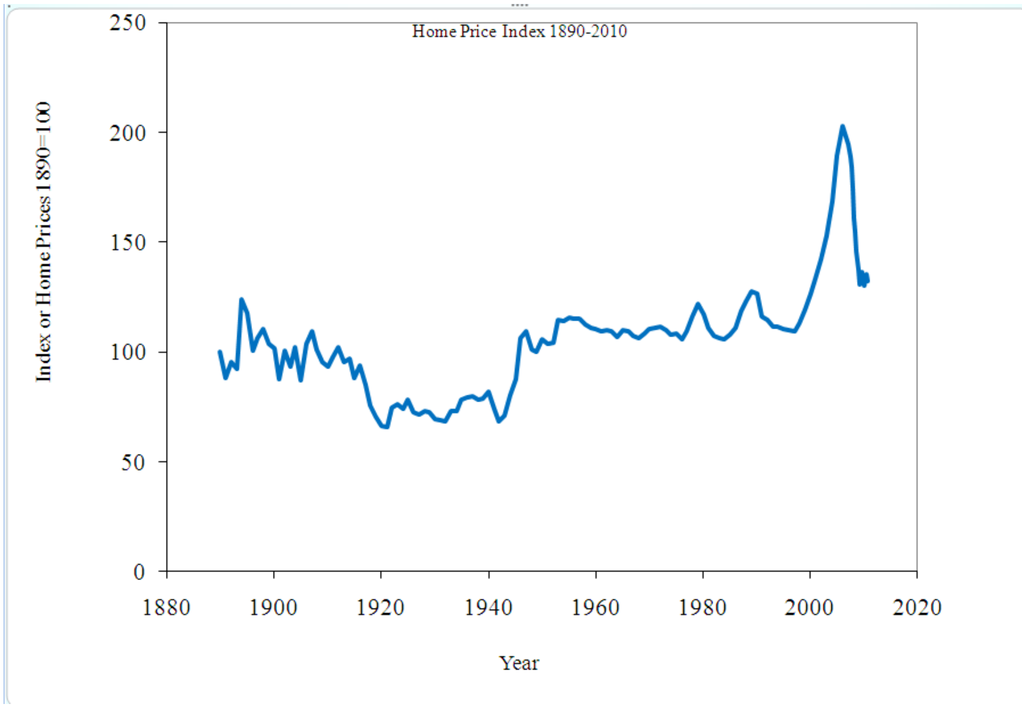
* Unless noted otherwise, the data are all from European Mortgage Federation (2008), an annual fact book that contains comprehensive mortgage and housing market data for 1998 to 2008 for the sixteen Western European countries and the United States.

** The mortgage interest rate spread equals the mortgage interest rate (column 5) relative to the government bond rate of each country derived from the International Financial Statistics of the International Monetary Fund.
Source: Dwight M. Jaffee, “Reforming the U.S. Mortgage Market through Private Market Incentives” (presentation, Federal Reserve Bank of St. Louis, November 17, 2010) http://research.stlouisfed.org/conferences/gse/Jaffee.pdf (accessed January 14, 2011).

Accordingly, there seems to be an overwhelming policy argument against continuing any government role in supporting housing finance. We’ve already realized all the benefits we’re likely to get from government involvement—a national mortgage market, standardized mortgages, and a workable system for bringing in funding from institutional investors—and it’s likely that if we bring the government in again we will have another taxpayer catastrophe on our hands some years from now. The only remaining questions are whether it will be possible to sustain a securitization system that allows institutional investors to support U.S. housing finance without a government guarantee on either mortgages or MBS, and how would a social policy of subsidizing home ownership for low-income families fit into this system.

A HOUSING FINANCE MARKET WITHOUT A GOVERNMENT ROLE

How would the housing market function without government support? The best way to start this analysis is to contrast the current state of the housing market with what prevailed in the past. We are now in the midst of a continuing deflation of a massive housing bubble, by far the largest bubble in our history. The following figure shows its growth in relation to bubbles of the past and its subsequent deflation.



There are at least three housing bubbles visible in this figure, one around 1980, another around 1990 and then the big one that started in about 1997, extended until 2007, and is now quickly deflating. Why is it that the two earlier bubbles were so small and short-lived in comparison to the most recent and destructive one? As I noted earlier, by 2008 the GSEs were exposed to the credit risk of 12 million subprime and Alt-A loans, while FHA and other government agencies accounted for an additional five million. According to Edward Pinto's research, approximately 2.2 million loans of this kind were also made by banks under the Community Reinvestment Act or by mortgage banks such as Countrywide under a HUD program that pledged them to use reduced down payments and underwriting standards generally in order to assist low-income families to buy homes. All these weak and high risk loans are in one way or another the result of government policies.

An additional 7.8 million loans were securitized by Countrywide and others, sold through Wall Street underwriters, and were still outstanding before the financial crisis. In an important sense, these loans were also the government's responsibility, because the funds the government poured in subprime and Alt-A loans during the 1990s and the 2000s drove the growth of the bubble, which in turn made it possible for Countrywide and others to originate and sell the private label MBS that formed about one-third of the weak and high risk mortgages outstanding.

Thus, there were approximately 27 million subprime and Alt-A loans outstanding in the U.S. before the financial crisis—about half of all U.S. mortgages. The following table summarizes these numbers and the dollar amounts involved.

Entity	No. of Subprime and Alt-A Loans	Unpaid Principal Amount
Fannie Mae and Freddie Mac	12 million	$1.8 trillion
FHA and other Federal*	5 million	$0.6 trillion
CRA and HUD Programs	2.2 million	$0.3 trillion
Total Federal Government	**19.2 million**	**$2.7 trillion**
Other (including subprime and Alt-A PMBS issued by Countrywide, Wall Street and others)	7.8 million	$1.9 trillion
Total	**27 million**	**$4.6 trillion**

* Includes Veterans Administration, Federal Home Loan Banks and others.

Source: See Edward Pinto's analysis in Exhibit 2 to the Triggers Memo, April 21, 2010, p. 4, http://www.aei.org/docLib/Pinto-Sizing-Total-Federal-Contributions.pdf.

The earlier bubbles had a far different composition. The 1980 bubble occurred at a time when subprime mortgages were very rare and Alt-A mortgages almost non-existent. When that bubble collapsed, the foreclosure starts, according to Mortgage Bankers Association (MBA) data, peaked at .87 percent in 1983.[16] When the 1990 bubble collapsed, subprime and other high-risk loans were still few and foreclosure starts peaked at 1.32 percent in 1994. However, in the case of the 1997–2007 bubble, almost half of which consisted of subprime or otherwise weak and high-risk loans, foreclosure starts have thus far reached 5.3 percent in 2009, even though the government has established a number of programs to prevent or reduce foreclosures.

In other words, there is very strong evidence that if mortgages are of prime quality, the likelihood of a large and long-lived bubble is much reduced. Indeed, the delinquency rates on the GSEs' prime loans averaged 2.6 percent for Fannie and 2.0 percent for Freddie in 2009, while the delinquency rates on their nonprime loans averaged, respectively 17.3 percent and 13.8 percent.[17] This leads to the conclusion that one way to assure that a securitization system for housing finance will work—without any government financial backing—is simply to ensure that the vast preponderance of mortgages, and all securitized mortgages, are of prime quality. Prime-quality mortgages are good investments. Historically, and even during the financial crisis, prime mortgages did not suffer high rates of delinquency. For this reason, after the markets return to normal, there should be no difficulty placing MBS based on prime quality mortgages with institutional investors in the U.S. and around the world.

Regulation is necessary in this case because there is strong evidence of market failure in the history of housing bubbles. As a bubble grows, people come to believe that "this time it's different." Borrowers seek to keep their down payments and monthly payments low over the short term with riskier loans and more leverage while they try to buy homes that have become more expensive. Lenders believe that the increasing value of homes limits their risks even on riskier mortgages. Investors, not seeing any increase in delinquencies while the bubble is growing (because higher home prices allow homeowners who can meet their mortgage obligations to sell or refinance the house), are willing to buy MBS backed by subprime loans. As we have seen time and again, all these market participants are wrong. Inside the bubble, risks are growing substantially, and when the bubble finally deflates the losses can be so severe that, as we saw in 2008, a serious financial panic erupts. Appropriate regulation can break this cycle, by requiring that all securitized mortgages meet certain quality tests.

[16] Mortgage Bankers Association National Delinquency Survey.

[17] Edward Pinto, "Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study," November 4, 2010, chart 53, http://www.aei.org/docLib/Government-Housing-Policies-Financial-Crisis-Pinto-102110.pdf.

The necessary regulation would not be complicated. It would require that all securitized mortgages would have to be of prime quality. That means the borrower, among other requirements, has (1) made a 10–20 percent downpayment or for a refinancing has equity in the home of at least 20 percent, (2) a debt-to-income ratio of no more than 38 percent, and (3) a FICO credit score of at least 660. It should be noted, too, that a loan that is otherwise prime could be substantially weakened by a second mortgage. In effect, a second lien increases the loan-to-value ratio of the first lien. One way to address this would be to require that second mortgages cannot be added to a property without the approval of the first lien holder.

The rules would be less stringent for loans held in the portfolios of banks and other financial institutions, but there must be disclosure of the quality of the mortgages outstanding so that participants in the market understand how many mortgages that don't meet prime standards are outstanding. This will allow them to estimate the severity of any subsequent downturn. A complete discussion of reforming the housing finance market along these lines is contained in an AEI white paper, published on January 20, 2011.[18]

EXAMPLES FROM ABROAD

Regulation of this kind is what makes other housing finance systems work as well as they do. The U.S. is one of a very few developed countries that back residential mortgages in any way, and those others that do supply some backing generally provide some kind of liquidity support rather than credit support. Most other countries in Europe and elsewhere rely on regulations that control mortgage quality to assure that their mortgage systems work.[19] A case in point is Denmark. It has an interesting system in which mortgage banks arrange for mortgages and take the credit risk, but the mortgage is funded in the open market, as part of a pool of mortgages of the same tenor. The quality of the mortgages that go into the system is strictly controlled, and because the mortgage banks assume the credit risk their interests are aligned with the buyers of the MBS issued by the mortgage pool. Germany has a covered bond system that also rests on regulations that strictly control the quality of the mortgages allowed into the cover system. Neither Denmark nor Germany backs any part of the mortgage financing system, which seems to work well because of the regulatory assurances of mortgage quality. In over 200 years there has never been a failure of a mortgage bank in Denmark or a failure to meet covered bond obligations in Germany.

LENDING TO LOW-INCOME BORROWERS

How would a social policy that provided government assistance for low-income families fare in this environment? The first point to note is that there is no internal inconsistency between a system which relies primarily on high-quality mortgages for steady functioning and a social policy that encourages concessionary loans to low income borrowers. Unless a new system is set up by Congress, FHA could continue to function as the insurer for loans to low-income borrowers. But certain restrictions would be necessary to protect the taxpayers, the borrowers, and the firms that are engaged in operating in the prime market.

First, all FHA commitments should be on budget, so that Congress and the taxpayers have an idea of the liabilities the FHA is assuming. FHA's obligations are currently covered by the Federal Credit Reform Act, but its accounting is very complex and makes it difficult to determine something as simple as whether its assets exceed its liabilities. Second, while the quality standards for FHA mortgages would be lower than those in the prime market, the agency cannot be allowed to function with no quality standards. Taxpayers should take some risks in support of social policies that are deemed worthwhile for the nation as a whole, but Congress has a responsibility to assure that there are limits on the size of these risks. In other words, lower FICO scores would be expected, but there would have to be a minimum. Down payments could be much lower than for prime mortgages. Finally, FHA should not compete with private originators or securitizers. They should be seen as two different markets. For example, FHA's support might be limited to borrowers who are at or below 80 percent of the median income in the area in which they live, and the size of any loan might be restricted to 100 percent of the median home price.

[18] Peter J. Wallison, Alex J. Pollock, Edward J. Pinto, Taking the Government Out of Housing Finance: Principles for Reforming the Housing Finance Market, American Enterprise Institute white paper, January 20, 2011, http://www.aei.org/docLib/HousingFinance.pdf.

[19] Barclays, "US Housing Finance: No Silver Bullet," December 13, 2010, Figure 3.

ELIMINATING FANNIE AND FREDDIE

Finally, if we were to adopt a housing finance system that relies on mortgage quality rather than a government guarantee to foster the sale of MBS, would Fannie and Freddie have any role? The answer is no. By helping to standardize mortgages and creating a national and international market for U.S. residential mortgages, Fannie and Freddie have fulfilled their mandate. A secondary market for jumbo mortgages exists and there is no reason why that market cannot be extended downward into the conforming market now dominated by the GSEs.

One of the advantages of a comprehensive reform of the housing finance market along the lines described in this paper is that it significantly simplifies the process of eliminating or privatizing Fannie and Freddie. Regulating the quality of mortgages so that we overcome the tendency of a housing market to create bubbles—and especially the tendency of a government-backed market to create large and potentially dangerous bubbles—will make it possible to eliminate the GSEs simply by reducing their conforming loan limits gradually over time. As the GSEs are gradually withdrawn from the housing finance market, private securitization of prime mortgages will take their place. In the AEI white paper referred to above, we recommended a reduction of 20 percent per year in both the regular and the high cost are conforming loan limits.

Of course, at this point in time, the securitization market is extremely weak; there are very few deals going forward. Many commentators may note that without a robust securitization market, the plan for reforming the housing market along the line outlined in this paper would not be workable. I agree; however, there is no reason in theory why the securitization of mortgages should not return to health once the quality of the mortgages is established. MBS backed by these mortgages are likely to be sought-after investments for institutional investors. Indeed, an article in the *New York Times* on January 15, 2011,[20] noted that the spread between the GSE rate for a 30-year fixed-rate mortgage and the nongovernment rate of a jumbo fixed rate mortgage was now only 60 basis points and coming down. This is significant. It suggests that the securitization market is beginning to revive. A 60 basis-point spread is high, but it has come down considerably from where it was after the financial crisis. In addition, the GSE rate may be artificially low because of the current government subsidization of the GSEs.

Assuming then that a robust securitization market develops, the following steps would be a workable way to wind down the GSEs:

- Provide by law for a reduction in the GSEs' conforming loan limit by 20 percent of the previous year's cap each year, starting with the current general limit for one-unit properties of $417,000 and the high-cost area limit of $729,750. If we assume an 80 percent LTV, the current limits allow mean house prices of over $500,000 and $900,000, respectively. In contrast, according to the National Association of Realtors, the median U.S. house price is $171,300.

- Under the conforming loans reductions schedule above, the general limit for a one-unit property would decrease to $334,000 in year one; $267,000 in year two; and $214,000 in year three. The high-cost area limit for a one-unit property would decrease to $584,000 in year one; $467,000 in year two; and $374,000 in year three.

- As the GSEs withdraw from markets larger than the conforming loan limits, private securitization will assume the role of providing a secondary market. If only prime mortgages are involved in these securitizations, the MBS should be attractive investments for banks, insurance companies, pension funds, mutual funds, and other institutional investors.

- At this point, the first formal review of the GSE transition would take place. If the transition is judged to be proceeding successfully, and unless the Congress votes to the contrary, the 20 percent annual reductions would continue through year five, reducing the general conforming loan limit to $171,200 and finally $136,960. The

[20] Jennifer Saranow Schultz, BUCKS; The Jumbo Rate Gap Shrinks, http://query.nytimes.com/gst/fullpage.html?res=9500E4DE153CF936A25752C0A9679D8B63&scp=1&sq=Jumbo+&st=nyt

high cost area conforming loan limit would be reduced to $299,200 in year four and $240,800 in year five.

- Final termination or "sunset" of GSE status would take place at the end of year five.

- From the beginning of the wind-down, the GSEs would be prohibited from adding to their portfolios of mortgages or MBS. These would be allowed to run off naturally, although if the market is strong enough they could be sold by the GSEs. The GSEs would not be permitted to hold loans or MBS in the GSEs' portfolios, except for short periods as necessary to support MBS issuance.

- During the wind-down period, Fannie and Freddie would be allowed to buy only prime loans and in order to prevent them from arbitraging their GSE status they would be permitted to invest only in short-term Treasury bills.

- At the sunset date, a liquidating trust would be created containing all remaining mortgage assets, guaranty liabilities, and debt. The trust would hold Treasury securities to be liquidated if necessary to meet the trust's obligations. When the last mortgage is refinanced or sold off by the trustee, the trust will be terminated and any remaining Treasury securities returned to the Treasury. The GSE net-worth shortfall will unjustly—but at this point unavoidably—be borne by taxpayers, including Treasury's writing off of its preferred stock.

- All of Fannie and Freddie's intellectual property, systems, securitization platforms, goodwill, customer relationships, and organizational capital should be auctioned off in a termination or privatization. The proceeds would reduce the Treasury's and taxpayers' losses.

CONCLUSION

The history of government support for housing finance shows that it invariably results in massive taxpayer losses, but produces very few of the benefits for the country—such as increases in homeownership or lower interest rates for housing finance—that the government is seeking. Instead of basing the financing of housing on government backing, a robust system of housing finance can be based on ensuring the quality of mortgages. This is how other developed countries generally structure their residential finance systems, and in doing so they achieve better outcomes than the U.S. without any substantial taxpayer costs. The administration's acceptance of this idea is a major advance, in that it enables those in Congress who are unable to support another government-backed system to make common cause with the administration. Once this system is adopted, and rules are in place that ensure mortgage quality, Fannie and Freddie can be gradually withdrawn from the market by reducing the conforming loan limit over a period of years. As that happens, it is highly likely that the private sector will take over the areas from which the GSEs have withdrawn.