Government Guarantees for the Secondary Mortgage Market

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*The views expressed are those of the author and not necessarily those of the Atlanta Fed or the Federal Reserve System.

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Introduction

The U.S. government has guaranteed mortgage-backed securities for almost 50 years -- initially through Ginnie Mae (FHA and VA loans) and later through sponsorship of Fannie Mae and Freddie Mac (conventional-conforming loans).

As we discuss "housing finance reform," my sense is that there is a broad consensus to retain government-backed mortgage insurance program(s) and the securitization of such loans through Ginnie Mae.

There is also material political support for government guarantees of conventional loan pools, although much debate about structure.

This presentation centers on some of the underlying economic issues associated with these guarantees, in an effort to provide broad context and spur discussion and debate as we kick-off the workshop.

To be clear, these are my views and not necessarily those of the Federal Reserve Bank of Atlanta or any other entity within the Federal Reserve System.

Historical Rationales for Fannie Mae and Freddie Mac

The economic policy rationale for Fannie Mae and Freddie Mac (collectively, the GSEs) – or their replacement -- has evolved over the years.

1.) Facilitated nationally integrated mortgage markets and geographic diversification of housing risk, as mortgage finance was a local enterprise.

- Deregulation and advances in information technology largely eliminated this rationale. Many banks and finance companies now operate nationwide.

2.) Mechanism to deliver interest rate subsidies and support homeownership.

- GSEs had modest effects on mortgage rates (<25 bps); and
- Likely no effect on homeownership rates (marginal borrowers are the purview of FHA/VA).

3.) A way to maintain financial stability generally, and to ensure broad credit availability and reduce mortgage rate volatility during unstable periods.

- Only works with explicit guarantees; comes with GE distortions.

Homeownership

U.S. public policy has long sought to encourage homeownership, but it does so in both broad and targeted ways.

Broad subsidies, such as tax deductions for mortgage interest and property taxes, strike many economists as inefficient and largely benefitting middle and upper income households that would own homes anyways.

- Overinvestment in housing; underinvestment in other sectors of the economy.
- GSEs contribute some to this effect.

Targeted subsidies, such as FHA mortgage insurance, are more appealing to economists as a mechanism to capture potential positive externalities associated with homeownership.

- Should focus on households straddling the rent/own margin.
- Many beneficiaries are low- and moderate income households, which makes subsidies further appealing on social equity grounds.

Mortgage Market & Financial Stability

Will the government absorb housing finance tail risk *ex post* regardless of the *ex ante* structure?

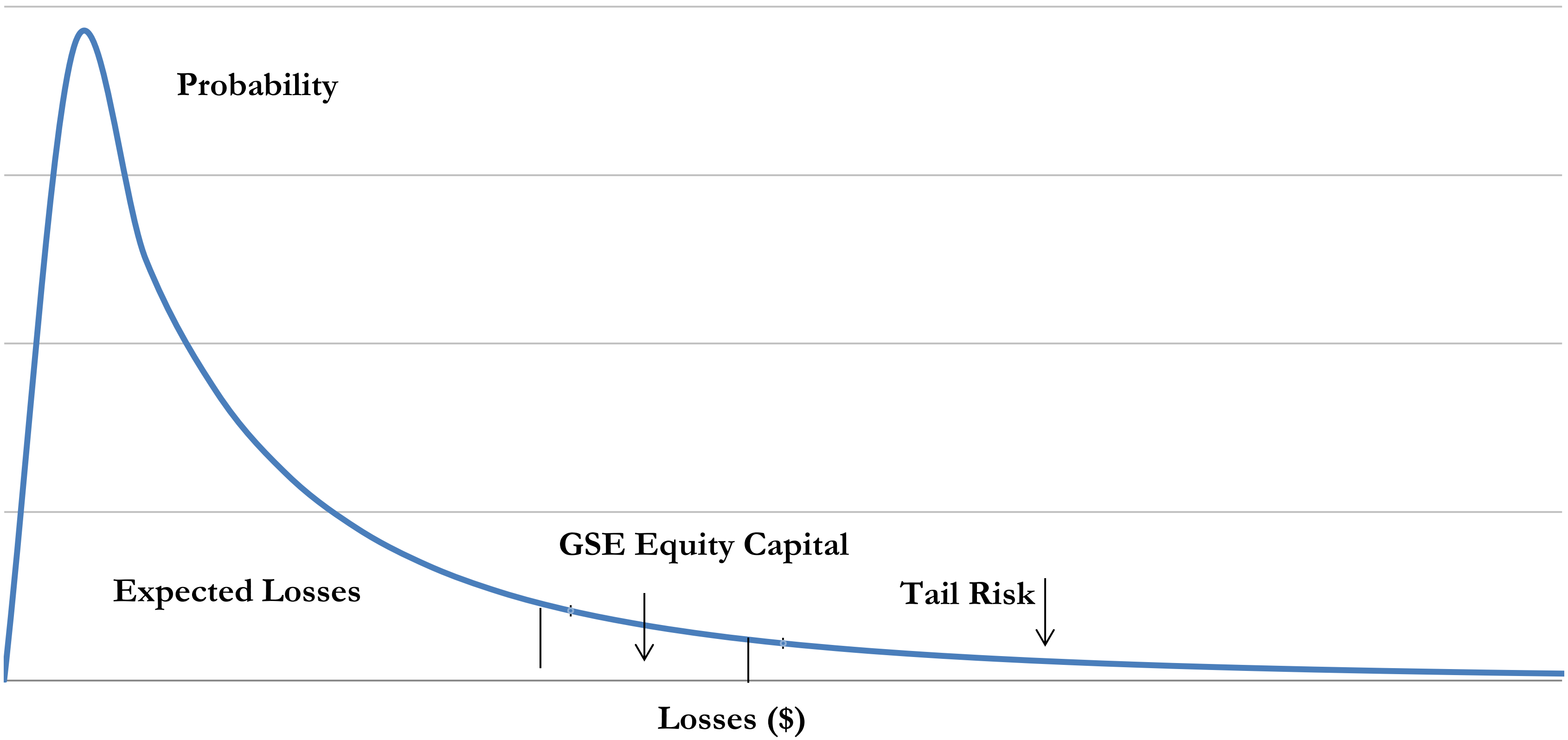
- Housing market health is too important to the overall economy, housing market collapses adversely affect too many voters, and any related moral hazard is unavoidable.
- Recent events certainly support this view.

If correct, one could argue that the government should:

- Strictly regulate program underwriting standards;
- Collect *ex ante* premiums from market participants to limit taxpayer losses;
- Establish the boundaries of any public-sector exposure *ex ante*; and
- Establish credible plans to resolve private-sector insolvencies that arise *ex post*.

Some call for the elimination of the GSEs without replacement -- arguing there is no market failure being addressed. This requires a financial system without explicit or implicit guarantees – very tall order post-crisis.

GSE Risk-Sharing Model & Mortgage Pool Losses



Location and shape of the curve depends on the amount and characteristics (riskiness) of the underlying mortgages.

Government Guarantees for Financial Stability

1.) Underwriting Standards.

- Tail size is determined by the characteristics of the underlying mortgages and the government's attachment point.
- May be helpful to have legislative parameters.
  - Delineation of this program versus Ginnie Mae-eligible loans.
  - Observable characteristics (e.g., Combined LTV maximum) and underwriting requirements (e.g., no "low doc" loans).
- Aim to reduce pro-cyclicality of mortgage credit.

2.) Pricing. Important that guarantee pricing be risk-based and include a return on equity commensurate with private market participants.

- Part of current FHFA approach.
- Tail risk is very difficult to estimate, but failure to consider is distortionary.
- Cross-subsidies within the credit box -- and assuming level-field capital regime -- could become unsustainable (disintermediation by portfolio lenders).

Over time, political pressure may lead to: underpricing the guarantee, covering riskier loans, and/or weaker prudential regulation and supervision.