Workshop on the Appropriate Government Role in U.S. Mortgage Markets

Comments for panel on **“Mortgage Access and Sustainable Economic Activity”**

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The government influences mortgage market largely through its provision of credit subsidies. Hence I will take the title of this session, “Mortgage Access and Sustainable Economic Activity,” as an opportunity to talk about the credit subsidies delivered through the federal housing agencies and the GSEs (or successor entities envisioned to make up the secondary mortgage market). I want to touch on three related issues: Are current subsidies consistent with goal of sustainable economic activity? What entities should deliver credit subsidies and how should they be paid for? And finally, how costly are those credit subsidies (and is there sustainable slack to pay for subsidies in current guarantee pricing)?

1. Are current subsidies consistent with sustainable economic activity?

This is clearly a question with no simple answer (and I won’t attempt one here). But in evaluating sustainability issues, I think there’re a few things to keep in mind.

There is often the presumption that imperfections in private credit markets necessitate government intervention to assure sufficient access to mortgage funding, and that the chronic state of affairs is insufficient credit availability.

However, given the enormous government footprint in the mortgage market today, the credit subsidies currently provided may be too big rather than too small, at least on average.

Why too large?

It is well understood that subsidies tend to encourage excessive investment, which is contrary to the goals of economic or ecological sustainability.

In fact, credit subsidies are only one element of government support for owner-occupied housing. By most estimates the tax code provides the largest benefits to homeowners. In evaluating the effects of credit policy on sustainability, credit subsidies have to be considered in the context of housing policies more broadly.

Another unintended consequence is that subsidies, and the greater access to mortgage credit that they make possible, boost the demand for housing. This in turn pushes up house prices. Some have argued that the benefits of mortgage subsidies largely accrue to existing homeowners through these price effects, and that affordability could actually decrease for first-time buyers.

To avoid such unintended consequences, it seems important as part of any mortgage market reform package to target mortgage subsidies more narrowly to achieve well-articulated goals than is the case currently.

2. What entities should deliver credit subsidies and how should they be funded?

Appealing to two principles --transparency and tax efficiency--mortgage credit subsidies should be on-budget and financed through broad-based taxes. The past and current practice of using the GSEs as a vector for credit subsidy delivery, effectively through unfunded mandates, violates both of these principles. And as a practical matter, the outcomes of current policies have been unsatisfactory.

Fannie and Freddie's charters require them to provide ongoing assistance to the secondary mortgage market, and to promote access to mortgage credit throughout the nation, including for low- and moderate income families and residents of central cities. Affordable housing goals were established in legislation and operationalized by regulators.

Although the GSEs usually met or exceeded those goals, the evidence suggests that they have not been a particularly effective or efficient way to support housing for low- and moderate-income families. Small reductions in interest rates are unlikely to have a large effect on affordability. Relaxing down-payment constraints has a larger positive effect on access, but at a potentially very high costs to homeowners experiencing defaults and to taxpayers.

For those reasons, I strongly believe that gov't credit support should be delivered through federal agencies, not through regulatory requirements that act as hidden taxes on financial institutions.

It's a positive sign that the leading reform proposals seem to be supportive of putting more of the subsidy function into a government agency such as FHA or a successor entity.

However, there is still often the sense that the “profits” earned by secondary market financial institutions should be used in part to subsidize higher risk mortgages for target populations.

Some reluctance to the idea of reprivatizing the mortgage market also may be related to the concern that the cash flow and policies used to support access via the GSEs would be lost.

That raises the question of how much profit there is in the system today, and whether it makes sense to think of those cash flows as a sustainable source of funds for affordable housing.

3. How costly is credit support for housing and is there slack in current pricing?

Recently I’ve been working on quantifying the cost of the current Treasury backstop through the preferred stock purchase agreements with the GSEs. I’ve also been thinking more broadly about the question of whether privatizing the GSEs would make or cost the government money (in a net present value sense).

My analysis of the value of the Treasury backstop suggests that in fact there are not a lot of real profits available to be redistributed under a continuation of current policy. That is, there is not a lot of slack available to support mortgage subsidies.

Although cash flows to Treasury in recent years have been positive, those cash flows do not represent profit because they do not take into account the value of the guarantees provided by the government, whose costs only become apparent infrequently as they did during the financial crisis. A present value analysis shows that the Treasury sweep is approximately fair compensation for the risk-bearing services provided by taxpayers—there is not a lot of slack in current pricing to pay for subsidies in a sustainable way.

Relatedly, we should not expect that privatizing Fannie and Freddie by selling them to private investors would generate large profits that could be tapped to pay for government programs to increase credit market access. That conclusion rests on the observations that current guarantee fees are still below market, F&Fs systems are aging, and that the only way private investors could get significant value from a privatization transaction would be from a continuation of underpriced gov’t guarantees or the granting of monopoly/duopoly power.