Government-Sponsored Enterprises and Financial Stability

Wayne Passmore
Federal Reserve Board
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Current Charter of Fannie Mae

- Sec. 301. The Congress declares that the purposes of this title are to establish secondary market facilities for residential mortgages, to provide that the operations thereof shall be financed by private capital to the maximum extent feasible, and to authorize such facilities to–
  - provide stability in the secondary market for residential mortgages;
  - respond appropriately to the private capital market;
  - provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families); …
  - promote access to mortgage credit throughout the Nation; …
  - and manage and liquidate federally-owned mortgage portfolios in an orderly manner...
- The charter suggests that the Congress wants the GSEs to play an active role in financial stability.

But do GSEs promote financial stability?

- Three major pre-crisis concerns (Gensler speech, 2000; Greenspan testimony, 2004):
  1. GSEs benefited from implicit government backing that resulted in lower funding costs and minimal regulatory capital.
     - At this time, over half of the GSE stock market value was due to the implicit subsidy, but primary mortgage rates were only 7 basis points lower (Passmore, Sherlund, and Burgess, 2003; Passmore, 2004).
     - The implicit guarantee resulted in the GSEs dominating the mortgage market, making high profits, and providing few social benefits.
  2. The GSE portfolios were considered a systemic risk.
  3. Market discipline was considered lacking, because there were private profits and socialized losses.
- Pre-crisis prescriptions:
  - Bank-like capital standards.
  - Stronger regulator.
  - Well-defined resolution process.
  - Limits on the size of GSE investment portfolios (and thereby limits on GSE debt issuance).
  - Any government guarantees should be transparent and explicit government.

What did the Housing and Economic Recovery Act of 2008 do?

- Pre-crisis prescriptions:
  - Bank-like capital standards. (Almost)
  - Stronger regulator. (Federal Housing Finance Agency)
  - Well-defined resolution process.
  - Limits on the size of GSE investment portfolios.
  - Any guarantees should be transparent and explicit.
- Shortly after HERA passed, Fannie Mae and Freddie Mac were put into conservatorship.
- Under HERA, the choice is continued conservatorship, receivership, or return to pre-conservatorship status.

Implicit and Explicit Government Guarantees

- An implicit guarantee exists when investors believe the government will intervene because not intervening leads to severe economic consequences.
  - Implicit guarantees reflect the problems of managing and pricing catastrophic risk.
  - Concerns exist that the private sector may have difficulty managing this risk without the belief or promise of government intervention.
- An explicit guarantee can be thought of as broader than an implicit guarantee:
  - It usually resolves the question about how the government intervenes in catastrophes.
  - But an explicit guarantee can go beyond the scope of an implicit guarantee.
  - The government can use explicit guarantees to reallocate credit and market activity to meet other objectives.
  - Explicit guarantees often reflect concerns about fairness and income redistribution as it relates to mortgage credit.
- By using explicit government guarantees, is the government managing catastrophic risk (which may be an unavoidable cost to government)?
- Or is the government redistributing housing from market outcomes (which is a policy choice)?

Are GSEs needed to manage catastrophic risk?

- The Great Depression/Recession scenario:
  - Home values fall.
  - Mortgages also fall in value because collateral values fall and borrowers have difficulty servicing mortgage debt.
  - Banks fail when the mortgages fall in value.
  - Bank failures worsen recessions, depressions, and financial crises.
- GSEs provide mortgage insurance.
  - Banks no longer bear credit risk.
  - The link between falling house prices and bank failures is broken.
  - Mortgages (as mortgage-backed securities) can be sold by banks at a "normal" market value into a secondary market, even in difficult times.
  - However, GSEs need to remain solvent over long horizons to assure MBS investors the GSE guarantee is credible.
  - This assurance is usually provided by the GSEs relationship to the government.
- Private mortgage insurance distributes credit risk, but it cannot solve the problem of catastrophic or system-wide failure (Hancock and Passmore, 2011, Brookings).

The Difficulties with Implicit Guarantees

- Implicit guarantees create liquidity, but they also can create liquidity problems if investors are concerned about GSE insolvency.
- There are at least two ways GSEs can become insolvent:
  1. Securitization creates first mover and adverse selection problems, which cause the market to doubt the quality of mortgage pools during a crisis (Heuson, Passmore and Sparks, 2001).
  2. GSEs (and the government generally) usually misprices catastrophic risk insurance in the run-up to a crisis (Hancock and Passmore, 2016).
- If GSEs are possibly insolvent, investors will lose confidence in GSE MBS unless government invention seems likely.
  - The "regular" government may need to intervene to convince investors GSEs have government backing (Passmore, Sparks, and von Hafften, 2017).
  - GSE failure itself may become a catastrophic event (important factor in fall 2008).
- Why not use an explicit guarantee or have the government directly through the central bank?

So why implicit guarantees?

- First, there’s a strong desire to keep GSEs “off-the-books” of the U.S. government.
- Second, private investors need long-term credit risk guarantees for a viable secondary market based on the 30-year fixed-rate mortgage.
  - With guarantees, securities backed by traditional fixed-rate mortgages maintain value even when the economic outlook is poor.
  - Otherwise, the market must price catastrophic premiums into mortgage rates.
    - The time horizon is too long for many private mortgage investors because severe recessions/depressions are likely over such a long time horizon.
  - Furthermore, the widespread use of 30-year fixed-rate mortgages enhances systemic default problems in severe economic downturns, because equity accumulates very slowly—or possibly not at all given options to refinance and extract equity.
    - Thus, 30-year fixed-rate mortgages rarely exist without substantial government backing.
- The unwillingness to put GSE obligations on the government balance sheet combined with the desire for the widespread use of the 30-year fixed-rate mortgage may create the need for provide investors to demand an implicit guarantee.
- By design, the system lacks private equity, both in institutional and at the homeowner level. But financial crisis usually harshly affects homeownership and thus gives the market confidence that the government will likely intervene.

Conclusion: The Dilemma of Implicit Guarantees

- The desire for more private capital behind GSE MBS (held by either intuitions or homeowners), which would limit the implicit government guarantee, results in more expensive mortgage credit.
- The government guarantee is usually sold too cheaply relative to the costs of catastrophic risk.
- The dilemma of implicitly guaranteeing private market investors against long-horizon credit risk is as follows:

More expensive 30-year fixed-rate mortgages (if you limit guarantees)	versus	More government risk-taking More mortgage mispricing More moral hazard More adverse selection

- The question is why can't the government be the government and offer an explicit guarantee?
- The answer is a strong desire not to add to government obligations.
- Given this constraint, the practical answer may be a mortgage that is better than the 30-year fixed-rate mortgage with regard to equity accumulation (e.g., Passmore and von Hafften, 2017). Such mortgages may exist but there's little motivation by either the GSEs or lenders to explore them.
- Conclusion: Financial instability (and government bailouts) may be unavoidable if GSE guarantees remain implicit and 30-year fixed-rate mortgages are widespread and low-cost.