Center for American Progress

Future of Housing Finance Reform

Why a Government Role Is Necessary for Smoothly Functioning Mortgage Markets

David Min November 2010

Introduction

Early next year, Washington housing and finance policymakers in the Obama administration and on Capitol Hill will be deep in debate about what to do with the nation's two mortgage finance giants, Fannie Mae and Freddie Mac, both of which are now in federal conservatorship after operating as "government-sponsored enterprises" in order to provide support for homeownership across our country. Fannie and Freddie, of course, are both costly casualties of the recent housing and financial crises after decades of providing mortgage finance to middle-class Americans, so figuring out how to replace them—and the functions they serve—is one of the key policy decisions Washington will make in 2011.

Many conservatives want to remove any government role from the mortgage finance markets, leaving private markets to meet the mortgage needs of U.S. residential home buyers. Most progressives recognize that our country's history and the experience of many other countries starkly illustrate the flaws inherent in the "purely private" approach favored by conservatives. A full withdrawal of the federal government from the mortgage markets would lead to radical and catastrophic changes in the U.S. mortgage markets and thus our housing markets, including:

- Limited availability of long-term, fixed-rate mortgages
- Sharp increases in the cost of mortgages
- Large reductions in the availability of mortgage credit
- A higher systemic susceptibility to housing bubbles
- A lack of mortgage credit during economic downturns

This memo will detail why all of these outcomes are inevitable if the federal government plays no role in our mortgage finance markets. Subsequent memos in this series on mortgage finance policy and housing policy will address other issues critical to the upcoming debate over how to reform the housing finance system.

History shows us the limitations of a purely private mortgage market

Prior to the introduction of the major housing and finance reforms of the 1930s (which established the Federal Housing Administration, the Federal Home Loan Bank System, the Federal Deposit Insurance Corporation, and Fannie Mae, among others), the United States had a mortgage system that closely resembled the purely private system that conservatives are arguing for today. From our contemporary perspective, this system was a total failure, demonstrating the perils of the mortgage system that conservatives would have us adopt.

Residential mortgages prior to the 1930s had many of the same features as the unregulated mortgage loans of the 2000s, with products similar to the subprime mortgages and so-called Alt-A mortgages—then as in the 2000s they were short term (typically 5-10 years), they were interest only, they carried a variable rate of interest, and they featured "bullet" payments of principal at term (unless borrowers could refinance these loans when they came due, they would have to pay off the outstanding loan balance).

Moreover, mortgages in this earlier era had high down payment requirements, typically more than 50 percent, and were offered at rates much higher than the ones we take for granted today. Mortgage finance was very expensive as well. As Federal Reserve Chairman Ben Bernanke noted in his August 2007 remarks at Jackson Hole, mortgages were extraordinarily costly by today's standards, despite the fact that they were short-duration, interest-only, and protected by high down payments. There were also large regional disparities in mortgage rates, with differentials of as much as 2- to- 4 percentage points between different parts of the country.[1]

Because home mortgages were scarce, expensive, and high risk, they were effectively confined to a very narrow band of Americans, with a much higher percentage of home purchases being cash only. As a result, homeownership was far less attainable than it is today, with a homeownership rate of 43.6 percent in 1940.[2]

Furthermore, even with the predominance of these lender-friendly features, the purely private mortgage system that existed prior to the 1930s was highly vulnerable to extreme bubble-and-bust cycles. During good times, a lack of regulatory restraints meant that there were no checks on excessive optimism and risk-taking in mortgage lending; heavily leveraged mortgage lending led to housing bubbles on a regular basis. And during bad times there were no sources of mortgage credit to prevent a freefall in the housing markets. As a result, the U.S. mortgage banking system regularly suffered banking panics every 5 to 10 years, which when it happened had high costs for individual homeowners and deleterious consequences on economic growth.[3]

In response to the last of these bust cycles, the Great Depression, policymakers enacted a series of major banking and housing finance reforms, which ushered in a new and successful era of mortgage market stability that lasted until the 2008 financial crisis. The key features of this new home mortgage finance system were:

- Strong risk regulation across all mortgage lenders to prevent excessive risk-taking and mitigate the problem of housing bubbles

- Broad availability of affordably priced, long-term, fixed-rate mortgages facilitated by government-owned institutions and government-sponsored enterprises, including the Federal Housing Administration, the Veterans Administration, the Federal Home Loan Bank System, and Fannie Mae

- The provision of mortgage credit during periods of market contraction or economic downturns, which often happened simultaneously, by these same institutions[4]

The net result of these reforms was to provide affordable housing options, including homeownership and affordably priced rental housing, to generations of American households, allowing them to save and invest the bulk of their income rather than spending this on shelter. It is not an exaggeration to claim that U.S. housing finance policy is the foundation for the social mobility upon which the ideal of the "American Dream" is based.

Moreover, because of the strong regulatory oversight of mortgage lenders, this system was extraordinarily stable, providing many decades of unprecedented stability to investors and borrowers alike—until the ascendance of laissez-faire conservative economic ideology led to a steep decline in prudent supervision over the housing and finance markets, resulting in the 2000s housing bubble and consequent bust.

International comparisons support the idea that a government role is necessary

The experience of other countries also undermines the argument that a purely private mortgage system can meet the policy goals we have laid out above. There is not a single sophisticated mortgage finance system in the world that does not have significant levels of government support, either through explicit or implicit guarantees. And there is certainly no sophisticated mortgage finance system that exemplifies the purely private markets approach favored by many of the strongest critics of the U.S. system.[5]

Some conservative critics of the U.S. system point to the Canadian mortgage system as an alternative model. But these same critics ignore the fact that as much as 70 percent of outstanding Canadian mortgage debt is explicitly guaranteed by that country's federal government, either through the explicit guarantee on mortgage insurance (roughly 45 percent) or through mortgages securitized by the government-owned Canada Mortgage and Housing Corporation (roughly 25 percent).[6]

Other critics point to the housing finance systems of Germany and Denmark, both of which largely rely upon private mortgage lending institutions issuing so-called "covered bonds"—a type of security that features aspects of both securitization and traditional corporate bonds—as "private market" alternatives to the U.S. system. But again, these comparisons disregard the significant government involvement in the private mortgage markets, which includes both stringent regulation and (implied) government guarantees standing behind these financial institutions in much the same way that the U.S. government implicitly stood behind Fannie and Freddie.

In both countries, the government exerts a significant degree of control over the operations of ostensibly private mortgage lenders, including through strong regulatory oversight and product restrictions. Denmark, for example, prior to 2007 placed restrictions on the ability of its banks to offer adjustable-rate or interest-only mortgages.[7] Germany places similar restrictions on the type of mortgages that can be used in covered bond offerings.[8] Additionally, in both countries, the mortgage banks that can issue covered bonds have a special relationship with the state.[9]

Given the strong interrelationships between these mortgage institutions and their governments, it is unsurprising that an implicit government guarantee behind the liabilities of these firms appears to exist. The governments of both Denmark and

Germany recently confirmed the perception that they stand behind their private mortgage lending institutions when they provided large bailouts to distressed mortgage lenders during the credit crisis of 2008.[10]

The argument that Germany and Denmark have a more "purely private" housing finance system than the United States also ignores the significant levels of direct subsidies and government support that these two countries provide for housing, especially rental housing.[11] And it also ignores the significantly lower homeownership rates of these countries—Germany at 40 percent and Denmark at 51 percent in the 2000s, as compared to a homeownership rate between 65 percent and 70 percent in the United States over the same period.[12]

Purely private mortgage lending would be a disaster

While the history of our own country and the experience of other countries strongly suggest that a government role is necessary for broad and stable mortgage liquidity, many conservatives argue that the significant development of the financial sector since the 1930s means that a purely private mortgage system could effectively serve the mortgage needs of Americans today. They point to the nascent recovery in the so-called jumbo mortgage markets, an area that lacks any government support because these mortgages are for the high end of the housing market, as evidence supporting the idea that the purely private markets can capably serve the mortgage markets.[13]

This argument is fundamentally flawed, for a number of reasons. First, it ignores the enormous size of the U.S. mortgage market, which currently has some $11 trillion in residential mortgage debt outstanding. The fact that the purely private markets may be able to meet the mortgage needs of a narrow, wealthy slice of homebuyers does not mean that they will be able to meet the mortgage needs of all Americans.

Second, and relatedly, this conservative argument ignores the limited investor appetite for long-term debt investments—the type of investments that fund home mortgages—in the absence of a government backstop. While investor demand for long-term sovereign debt is enormous, totaling many trillions of dollars for U.S. Treasuries alone, the demand for privately issued long-term mortgage obligations that don't carry a government backstop is small in comparison.[14] As Federal Reserve Chairman Bernanke has notesd, the "essentially unhedgeable interest rate risk and default risk associated with mortgages" has historically created significant illiquidity in the mortgage markets" in the absence of government guarantees.[15]

Without a government backing, it is simply inconceivable that there would be sufficient investment capital to fund the $11 trillion in U.S. residential debt outstanding, let alone to fund longer-term mortgages, such as the 15-year to 30-year fixed-rate mortgages that dominate the U.S. mortgage market. Almost certainly, the removal of the government's role in the mortgage markets would result in sharp reductions in the availability of mortgage credit and an immediate transition to short-duration mortgages, such as the two-year and three-year adjustable-rate mortgages that dominated the purely private subprime and Alt-A markets during the 2000s.

Finally, the conservative argument ignores the highly cyclical nature of private mortgage lending. One of the major weaknesses of mortgage lending is the unavailability of mortgage credit during housing market or economic downturns as lenders become highly risk averse. This in turn can quickly lead to a "vicious circle" where a lack of available mortgage credit exacerbates the housing downturn, accelerating price declines and causing more mortgage defaults, which then leads to an even greater risk aversion on the part of lenders to provide credit.[16]

Left unchecked, this vicious circle can have devastating economic consequences. Since the 1930-era reforms, this type of "countercyclical" lending was provided by government-backed institutions. As a result, the United States avoided the more severe economic downturns that were so common up to the Great Depression and ending in the 1940s. In the absence of any government role in the mortgage markets, it is clear that our housing markets would be highly vulnerable to this problem of unavailable mortgage credit during housing downturns.

Conclusion

To summarize, there are many reasons, including our own country's experience and that of other countries, to believe that the conservative vision of a "purely private" mortgage market would lead to mortgage credit that was tightly constrained, unavailable during housing downturns, much more expensive, and highly onerous for homeowners.

In our next memo on the U.S. mortgage finance market we will present the argument in favor of the 30-year, fixed-rate mortgage over other types of mortgage loans. Watch this space.

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Endnotes

1 *See* Ben S. Bernanke, "Housing, Housing Finance, and Monetary Policy," August. 31, 2007, available at http://www.federalreserve.gov/newsevents/speech/bernanke20070831a.htm.

2 Richard K. Green and Susan M. Wachter, "The American Mortgage in Historical and International Context," *Journal of Economic Perspectives* 19 (4) (2005): 93–114, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=908976.

3 Gary B. Gorton, "Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007," prepared for the Federal Reserve Bank of Atlanta's 2009 Financial Markets Conference: Financial Innovation and Crises, May 9, 2009, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1401882; David C. Wheelock, "The Federal Response to Home Mortgage Distress: Lessons from the Great Depression," *Federal Reserve Bank of St. Louis Review*, May/June 2008, p. 134–139, available at http://research.stlouisfed.org/publications/review/08/05/Wheelock.pdf.

4 Adam Levitin and Susan Wachter, "Rebuilding Housing Finance." Working Paper, not yet published.

5 Herman Schwartz and Leonard Seabrooke, "Varieties of Residential Capitalism in the International Political Economy: Old Welfare States and the New Politics of Housing," *Comparative European Politics* 6 (2008): 237–261, available at http://people.virginia.edu/~hms2f/varieties.pdf; Peter J. Wallison, "Going Cold Turkey: Three Ways to End Fannie and Freddie without Slicing Up the Taxpayers" (Washington: American Enterprise Institute, 2010), available at http://www.aei.org/outlook/100993.

6 John Kiff, "Canadian Residential Mortgage Markets: Boring But Effective?". Working Paper WP/09/130 (International Monetary Fund, 2009), available at http://www.imf.org/external/pubs/ft/wp/2009/wp09130.pdf.

7 Realkreditradet, "The traditional Danish mortgage model" (October 2009), available at http://www.realkreditraadet.dk/Files/Filer/Engelsk/2010/Publikation_engelsk.PDF.

8 Jens Tolckmitt and Dr. Otmar Stocker, "The Legal Framework for Issuing Pfandbriefe" (Berlin: Association of German Pfandbrief Banks, 2009), available at http://www.pfandbrief.org/cms/bcenter.nsf/startdownload?readform&id=41495871&lang=en.

9 In Germany, the mortgage bank must meet a series of requirements demonstrating its ability and commitment to promoting covered bond liquidity on a regular and sustained basis in order to receive a license to issue covered bonds. See: Tolckmitt and Stocker, "The Legal Framework," p. 4. In Denmark, starting in 1970, the government began a conscious policy of encouraging concentration among its mortgage banks through mergers and acquisitions. See: "The traditional Danish mortgage model," p. 29. As a result, the five largest mortgage banks account for virtually all Danish mortgage lending, with a 95 percent market share in 2003. See International Monetary Fund, "Technical Note—The Danish Mortgage Market: A Comparative Analysis" (2006), available at http://www.imf.org/external/pubs/ft/scr/2007/cr07123.pdf.

10 In October 2008, Germany set up the "Special Fund Financial Market Stabilization," or SoFFin, which had provided nearly 150 billion Euros in bailouts to support the liabilities of 10 financial institutions, including one issuer of covered bonds and three Landesbanks (another type of German mortgage lender). See: Bundesanstalt fur Finanzdienstleistunsaufsicht, "Annual Report of the Federal Financial Supervisory Authority" (2008), available at http://www.bafin.de/cln_152/nn_720486/SharedDocs/Downloads/EN/Service/Jahresberichte/2008/annualreport__08__complete,templateId=raw,property=publicationFile.pdf/annualreport_08_complete.pdf. Also in October 2008, Denmark announced a sweeping guarantee of all deposits and senior debt issued by its banks. See: Neelie Kroes, "Guarantee scheme for banks in Denmark," European Commission Memorandum, State Aid NN51/2008 – Denmark, available at http://ec.europa.eu/community_law/state_aids/comp-2008/nn051-08.pdf. While this guarantee scheme did not apply to covered bonds directly, it bailed out the liabilities of the institutions issuing covered bonds, ensuring that they would have sufficient assets and liquidity to meet their covered bond obligations.

11 Volker Busch-Geertsema, "Housing Policy in Germany" (Bremen: GISS, 2000), available at http://www.iccr-international.org/impact/docs/housing-policies-de.pdf; Espen Erlandsen, Jens Lundsgaard, and Felix Huefner, "The Danish Housing Market: Less Subsidy and More Flexibility." Working Paper 513 (Organisation for Economic Cooperation and Development, 2006), available at http://www.oecd.org/officialdocuments/displaydocument/?doclanguage=en&cote=ECO/WKP(2006)41.

12 The rates for Germany and Denmark were as of 2004, a date presumably chosen because it was prior to the onset of the European housing bubble, as well as major changes in Danish underwriting that facilitated a flood of adjustable-rate and interest-only loans in Denmark that displaced the traditional 30-year Danish mortgage. See: Schwartz and Seabrooke, "Varieties of Residential Capitalism," p. 14. Also see: Bureau of the Census, *Table 5: Homeownership Rates for the U.S.: 1968-2010* (Department of Commerce, 2010), available at http://www.census.gov/hhes/www/housing/hvs/qtr210/files/tab5.xls.

13 Wallison, "Going Cold Turkey."

14 Bryan J. Noeth and Rajdeep Sengupta, "Flight to Safety and U.S. Treasury Securities," *The Regional Economist* 18 (3) (2010): 18–19 available at http://www.stlouisfed.org/publications/re/articles/?id=1984.

15 Bernanke, "Housing, Housing Finance, and Monetary Policy."

16 Joint Economic Committee Majority Staff, "From Wall Street to Main Street: Understanding How the Credit Crisis Affects You" (2008).