Center for American Progress

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The Perils of Privatizing the U.S. Mortgage Finance System

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March 2011

Introduction and summary

The U.S. Congress and the Obama administration are now earnestly engaged in the complicated process of reforming our nation's mortgage finance system. The decisions they make will have enormous impacts on the shape of the U.S. financial markets and may well decide whether homeownership remains a part of the American Dream for middle-class families or instead a distant hope for only the wealthy.

Increasingly, many conservatives are calling for the privatization of the mortgage markets, advocating the winding down of the mortgage giants Fannie Mae and Freddie Mac without any replacement. This privatization argument ignores the fact that the modern U.S. banking system, which provided an unprecedented degree of stability and prosperity from the 1940s through the early 2000s, was dependent on a strong government role, including a high degree of risk regulation and a government backstop— in the form of a federal guarantee for deposit insurance and a federal guarantee for mortgage-backed securities issued by Fannie and Freddie.

In a white paper published late last year by the Center for American Progress, "Future of Housing Finance Reform," I demonstrated that privatizing the mortgage markets would result in some fairly radical changes, including:

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

In response to these facts, advocates of privatization largely responded with two arguments. First, they criticized the alternative to privatization—namely, providing a government guarantee of some kind on home mortgages—claiming that this would provide a major benefit to the banking industry. Second, privatization advocates argued that the private sector can provide 30-year fixed-rate mortgages and broad liquidity—despite the large amount of evidence to the contrary. They point to the historic availability of affordably priced 30-year fixed-rate loans (at least up until the financial crisis) in the so-called jumbo market, which serves borrowers seeking high-balance loans, as evidence that a privatized system can meet the needs of the broader mortgage market.

Both of these claims are flawed. The first claim—that an explicit government guarantee would unduly benefit the banking industry—is wrong in several ways. First, it ignores the fact that a government guarantee already exists for "too big to fail" financial institutions, as evidenced by both the 2008 bailouts (both the Troubled Asset Relief Program and the various Federal Reserve programs) and recent studies indicating that these firms enjoy a "too big to fail" subsidy in their cost of funding.[1]

Second, it ignores the fact that these same "too big to fail" financial institutions would be the primary beneficiaries of a privatized mortgage finance system because they are the only ones with either the securitization infrastructure or excess balance sheet capacity to significantly increase their mortgage financing activities. As such, privatizing the U.S. mortgage market would deliver up to these big financial institutions a major windfall, further cementing their status as "too big to fail," particularly given the high systemic importance of residential mortgage debt.

Finally, this claim ignores the fact that a well-designed explicit government guarantee, with large buffers against loss such as an insurance fund and high capital requirements, would be far more onerous for these large financial institutions than the free, unpaid guarantee that they already enjoy by virtue of being "too big to fail."

In the aggregate, then, privatization would provide a far greater benefit to the banking industry and pose a far greater risk to taxpayers than an explicit, well-designed government guarantee. To the extent that privatization led to "too big to fail" banks taking on a greater role in the $10 trillion U.S. residential mortgage market, this would increase taxpayer exposure to losses due to the implied guarantee on the liabilities of such firms, without any corresponding increase in the protections (stringent regulation, an insurance fund) that ordinarily accompany such a guarantee.

The second claim—that the jumbo mortgage market proves that a privatized system would widely provide good mortgage products such as the 30-year fixed-rate mortgage—is also deficient. The jumbo market provides mortgages, for the most part, to high-income, high-wealth borrowers. No one disputes that purely private markets can serve this market well, just as they have always done.

In fact, our current system explicitly assumes that more wealthy Americans can receive mortgage finance without a government guarantee, which is why there are dollar limits on the loans Fannie and Freddie can securitize. But because the jumbo markets historically served this limited market segment does not provide any evidence it can serve the much larger "conforming market" of home mortgages currently served by Fannie and Freddie.

Conversely, there are many reasons to believe the jumbo market would not provide either broad liquidity or continue to provide 30-year fixed-rate mortgages if we privatized the U.S. mortgage markets. As our white paper demonstrates, the experiences we have had with purely private mortgage markets, including during the pre-New Deal era as well as in the contemporary commercial real estate market, give us some strong data points indicating that a privatized mortgage market would lead to sharp reductions in liquidity and the unavailability of the 30-year fixed-rate loan for most Americans.

The jumbo market generally favors adjustable-rate mortgages over 30-year fixed-rate loans, originating more ARMs than fixed-rate mortgages in most years, and far more so than in the conforming market served by Fannie and Freddie. To the extent that the jumbo market has offered 30-year fixed-rate loans, these have been integrally tied to the government-supported segment of the market.

Obviously, Fannie and Freddie historically set a market standard in providing affordably priced 30-year fixed-rate mortgages, one the jumbo market must compete with. Fannie and Freddie also historically provided the market infrastructure that facilitates the availability of affordable jumbo 30-year fixed-rate loans. Jumbo lenders have largely hedged these mortgages through the deep and liquid forward markets for Fannie and Freddie securities.

In short, if we privatized the market served by Fannie and Freddie, we would be removing both the incentive *and* the ability of private lenders to offer affordable 30-year fixed-rate loans.

Moreover, there are serious reasons to question the scalability of private mortgage finance in the absence of a government role. Currently, there are two main sources for private mortgage financing:

- Deposit-backed loans offered by banks and thrifts, which of course are also guaranteed by the federal government through the Federal Deposit Insurance Corporation

- Private-label mortgage securitization, the Wall Street-dominated process of bundling mortgages and issuing securities to investors based on the cash flows from those mortgages

It is highly unlikely either of these are capable of accounting for a significant increase in mortgage financing, for reasons explained in detail in the pages that follow. In the absence of a government guarantee, it is difficult to understand where mortgage liquidity would come from, with the near-certain outcome being a major reduction in the availability of mortgage loans.

Certainly, there were major problems with Fannie and Freddie—problems that must be addressed as Congress and the Obama administration move ahead with housing finance reform. But policymakers should also acknowledge the significant benefits provided by these entities as well. The clear and sensible policy solution should be to try to keep as many of the benefits we enjoy as possible while eliminating the problems.

Privatizing the mortgage markets would do exactly the opposite, eliminating the benefits provided by the current system, among them broad liquidity and the availability of consumer-friendly products like the 30-year fixed-rate loan, while entrenching or even worsening problems such as taxpayer risk, implied government guarantees for private financial institutions, and "too big to fail."

Advocates of privatization provide sound advice in warning policymakers to avoid recreating the government-sponsored entities. But at the same time, policymakers should be even warier of recreating the private-label securitization system of the past via complete privatization of the U.S. mortgage market, which was after all far more culpable in causing the recent mortgage crisis and the taxpayer losses that resulted.

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