

Bringing Back Subprime?

The Hazards of Restructuring the GSEs

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Executive Summary

There have been a number of proposals for replacing the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, with a system under which private financial institutions would issue mortgage-backed securities (MBS) that carry a government guarantee. This paper raises a number of questions about the merits of such a system. It points out:

- 1) **The gains to low-income families seeking to become homeowners from such a system would be relatively modest.** This is first and foremost because most low-income families who become homeowners only remain as homeowners for a relatively short period of time. This means the vast majority of the interest rate savings from a system of government guarantees would go to middle-income and wealthy homeowners.
- 2) **The interest rate savings are likely to be relatively modest.** In the years before the bubble, Federal Reserve Board research showed the savings on mortgage interest rates from the implicit government guarantee provided through the GSEs was less than 10 basis points. Even if this research understated the true risk premium by 80 percent, it would still imply an interest rate savings of less than 50 basis points. This would imply monthly savings of \$47 a month on a \$160,000 mortgage, if none of the lower interest costs are capitalized into the price of the home. If half of the savings are capitalized into house prices then the savings would be \$24 a month.
- 3) **There are few obvious safeguards that would make this new system sounder than the system of privately-issued mortgage-backed securities in the bubble years.** Under current plans, mortgages issued with just 5 percent down could be placed in pools with no requirement that issuers keep any stake. Given the random variation in appraisals, this virtually guarantees that a substantial number of underwater mortgages will be placed in pools.

The fact that the rating system for mortgage-backed securities was not fundamentally altered provides little reason for confidence that the rating agencies won't again shop for business by lowering standards. The main difference between the privately-issued MBS in the bubble years and the ones that would be issued in this reformed system is that the latter would carry a government guarantee for 90 percent of their value.

There can be a useful role for the government in reducing the cost of mortgages to homeowners. This is being done effectively now by Fannie Mae and Freddie Mac, operating essentially as publicly-owned companies. However, bringing the private sector into the securitization process with an explicit government guarantee creates substantial problems of moral hazard. The risk far outweighs any potential benefit. While there is arguably a public interest in subsidizing homeownership, there is no public interest in subsidizing mortgage-backed securities.

Introduction

The United States has long had a goal of promoting homeownership, with the idea that homeownership is a mechanism to promote stability in both families and communities, and also as a means for wealth building among low- and middle-income households. This has been the logic behind subsidies to homeowners, such as the mortgage interest deduction, and various forms of government-subsidized mortgages, such as those provided with the support of the Federal Housing Authority or the various government-sponsored enterprises (GSEs), including Fannie Mae and Freddie Mac.

By explicitly subsidizing housing through the tax code, or implicitly through mortgages subsidized by government guarantees, the federal government is effectively deciding that homeownership is a sufficiently valuable goal and that it is worth sacrificing some amount of economic growth and job creation to advance it. These subsidies have the effect of diverting capital from more productive uses. Standard economic models would show that this diversion of capital from more productive uses to housing results in lower productivity growth and therefore lower overall growth. It also would mean less job creation and slower wage growth.¹ Congress may view it as desirable to sacrifice some amount of economic growth and jobs in order to advance the goal of increased homeownership, but it is important that it recognize that the subsidies to achieve this end do come with a price, even when they don't appear as explicit items in the budget

It is also important to recognize that the benefits of homeownership to low-income households are less clear than is often recognized. While there are many examples of low-income families who stay in their homes for decades, and thereby manage to accumulate substantial equity, these are the exceptions. Many low-income families that become homeowners find themselves unable to remain as homeowners to long periods of time. For example, a recent study found that among low-income households who become homeowners, 36 percent had returned to being renters within two years. Within five years, 53 percent had returned to be renters. There was a similar pattern among minorities, with more than half of the African Americans and Hispanics in the study returning to being renters within 4 years of buying a home.² It is worth noting that these data were taken from the 1970s, 1980s, and 1990s, long before the boom in subprime lending in the last decade, so this has been an ongoing problem, not just an issue that came about as a result of the collapse of the housing bubble. For these short-term homeowners, the decision to buy a home was likely a drain on savings and wealth, since they most likely did not recover the transactions costs associated with buying and selling a home.

Current Proposals

Since the collapse of the housing bubble, there have been dozens of proposals for housing market reform. As the Center for American Progress states, “most serious plans for reform

¹ The theory of the economic costs of housing subsidies is discussed in Rosen (1983).

² These data are taken from Reid (2004). See also Haurin and Rosenthal (2004).

share at least three ... components: a limited and explicit government guarantee [on qualifying mortgage-backed securities]; a bigger role for private capital; and careful government oversight.”³

Most of these proposals would involve the largest change to the system of mortgage finance in this country since the creation of Fannie Mae in the Great Depression. As such, it is crucial to think carefully about the goals of the country’s housing policy and the extent to which they would be advanced by these plans. In particular, the mortgage structure proposed in many of the plans could create the sort of moral hazard problem that had such disastrous consequences in the housing market and the larger economy in the last decade. In fact, for reasons explained below, the moral hazard problem would likely be more serious with the guarantee system put in place under the bill. Also, although the risks from the system of mortgage finance envisioned in several of the proposals are large, the potential benefits and its impact in increasing homeownership are quite limited.

As “the first serious, bipartisan measure to do something about Fannie and Freddie,”⁴ S. 1217, the Housing Finance Reform and Taxpayer Protection Act of 2013, has emerged recently as arguably the leading housing market reform bill on Capitol Hill. Given the goal of increasing homeownership, however, it is not clear that this is a step in the right direction. It is important to recognize first and foremost that it is a proposal to subsidize mortgage-backed securities (MBS). This is two steps removed from subsidizing homeownership. It will only increase homeownership if:

- 1) the subsidy for mortgage-backed securities leads to lower mortgage interest rates; and
- 2) lower mortgage interest rates lead to an increase in homeownership.

There is more ambiguity on both of these questions than is generally recognized.

On the first point, it is not clear how much the government guarantee provided to MBS created through the system laid out in plans such as S.1217 would actually lower mortgage interest rates. Unfortunately much of the recent discussion on this issue has been somewhat confused. For example, Levitin argued that in the absence of a government guarantee structure, the private market would only provide a limited amount of housing finance, which would only go to homebuyers who already had considerable wealth.⁵

Levitin reaches this conclusion by examining the types of mortgages that are being placed in private issues of mortgage-backed securities in the post-crisis era. This sort of examination provides no insight whatsoever as to the availability of housing credit in the private market in the absence of a government guarantee.

Due to fact that private issuers have to compete with Fannie Mae and Freddie Mac, who are now operating with explicit government guarantees, it would be astounding if there was any

3 Griffith (2012).

4 DePillis (2013).

5 Levitan (2013).

volume whatsoever of privately-securitized mortgages that met the GSEs' standards. With the conforming loan limit having been raised as high as \$729,750 (80 percent loan-to-value on a \$912,000 house) in the years following the collapse of the housing bubble, this only left the very top end of the market as mortgages that could potentially be securitized by private issuers.

For this reason, it is hardly surprising that an analysis of the mortgages that have been securitized by private issuers in recent years would show that they are overwhelmingly high-end mortgages. Levitin's analysis exaggerates this skewing further by using averages rather than medians. An average of high-end mortgages will be disproportionately driven by the characteristics of very high-end outliers.⁶

The existence of GSEs operating with explicit government guarantees not only influences the supply of mortgages to private issuers, but it also affects the supply of funds. Lenders who have the option to purchase MBS issued by the GSEs will be less willing to make money available to mortgage financing through other channels. However, if lenders no longer have the option of purchasing MBS issued by the GSEs, they would likely be more willing to buy privately-issued MBS or to make funds available to banks on terms that may facilitate their holding of mortgages. While assessing the shape of the housing finance market in the absence of GSEs is unavoidably speculative, it is clearly wrong to infer that it would look the same as it does with the GSEs.

It is worth noting that the research on this topic prior to the expansion and implosion of the housing bubble found very limited effects from the then-implicit government guarantee to the GSEs. Research by the Federal Reserve Board (Fed) produced a central estimate of the savings from the implicit government guarantee given to the GSEs of just 7 basis points on a 30-year mortgage, with a high-end estimate of 15 basis points.⁷ These savings would not likely have a major effect on homeownership by low-income households.

Arguably, the crisis has permanently altered the risk associated with mortgage lending (the Fed may also have underestimated the risk premium at the time), but even if the Fed's high-end estimate was tripled, the impact on homeownership would still be limited. Mortgage interest rates have already risen by more than a full percentage point since their lows last year. This increase would be close to 20 times the savings from an implicit GSE guarantee, based on the Fed's central estimate, and 8 times the savings using the Fed's high-end estimate.

Furthermore, a substantial portion of interest rate savings are likely to be reflected in higher home prices. In other words, lower interest rates would be expected to lead to higher sales prices, other factors held equal. Just to give a simple example, if a homebuyer took out a 30-

⁶ To see this point, suppose that a pool with 20 mortgages has 19 issued for \$750,000 at 80 percent loan-to-value and one mortgage issued at \$10 million at 33 percent loan-to-value. While the median mortgage for this group would be for \$750,000 at 80 percent loan-to-value, the average mortgage would be \$1,213,000, at 50.7 percent loan-to-value. Clearly the median would provide a much more accurate description of the typical mortgage in this pool.

⁷ Passmore (2003).

year fixed-rate mortgage, for 80 percent loan-to-value on a \$200,000 home, at a 4.5 percent interest rate, his or her monthly payment would be \$811, as shown in the first column in the table below. If the interest rate fell to 4.0 percent on the same loan, the monthly payment would fall to \$764; in addition, the buyer would accumulate principal more rapidly.

Since homebuyers would be able to pay more for homes if mortgage rates fall, lower interest rates are likely to lead to an increase in home prices. Continuing the example above, if the price of the home increases enough to offset a decline in mortgage interest rates to keep monthly payments constant, the price would be \$212,260 after interest rates fall to 4.0 percent, as shown in column 3. (For simplicity, this calculation ignores property taxes, insurance, and other maintenance costs.) By definition, the monthly mortgage payment would be the same as when the home price was \$200,000 and the mortgage interest rate was 4.5 percent. While the monthly mortgage payments would be the same as in column 1, the transactions costs associated with buying and selling the home (e.g. realtors' fees, points on mortgages, inspection and surveyor fees, etc.) would have risen in proportion with the price. If these costs were 10 percent of the purchase price, then the transactions costs would have risen from \$20,000 (in the case where the interest rate was 4.5 percent and the home price was \$200,000) to \$21,260 (in the case where the drop in interest rates caused the home price to rise to \$212,260) as shown in row 3.

TABLE 1
Effects of Lower Interest Rates on Homeowner Costs

	4.5% interest rate	4.0% interest rate		
		Zero capitalized	Fully capitalized	Half capitalized
Home price	\$200,000	\$200,000	\$212,260	\$206,130
Monthly mortgage payment	\$811	\$764	\$811	\$787
Total transactions costs (10 percent of price)	\$20,000	\$20,000	\$21,260	\$20,613
Monthly transactions costs averaged over 5 years	\$333	\$333	\$354	\$344

Source: Authors' calculations.

An increase in transactions costs would not be a major factor for homeowners who stay in their homes for 15 or 20 years. Spread over this long of a time horizon, these costs would be far exceeded by the mortgage savings. But if homeowners do not stay in their homes for a long period of time, as will be true of many low-income homeowners, the rise in transactions costs could easily offset the gains from lower mortgage interest rates. Row 4 shows the transactions costs on a monthly basis for a homeowner who stays in a home for 5 years, which would be typical for low-income homeowners.⁸

In the extreme case where a drop in mortgage interest rates is fully capitalized into the price of a home, a homeowner who does not remain in the home for a substantial period of time could actually end up losing, since the higher transactions costs could end up more than offsetting the savings on interest. In a more realistic scenario, where half of the interest

⁸ Reid (2004).

savings are reflected in higher home prices (shown in column 4), it is less likely that a homeowner would end up losing as a result of lower interest rates. However, the impact of higher home prices on transactions costs will still disproportionately hurt homeowners who do not remain in their homes for a long period of time. Since low-income homebuyers do not typically stay in their homes as long as more affluent homebuyers, a general decline in mortgage interest rates will disproportionately benefit higher-income homeowners. It is also important to remember that insofar as the size of the monthly payment or the down payment is a major obstacle to homeownership, the impact of lower interest rates in raising home prices will limit the extent to which they promote homeownership.

There is one last point worth considering in assessing the potential gains from the system of government-guaranteed MBS proposed in plans such as S.1217. Much of the discussion of this system has focused on 30-year fixed-rate mortgages. While most homebuyers have generally opted for these mortgages, it is not always the best option for homeowners, nor is it obvious that the public has an interest in promoting these mortgages over other types of mortgages. Alan Greenspan famously commented in early 2004 that research from the Federal Reserve Board showed that many homeowners wasted thousands of dollars in higher interest costs and points by getting 30-year fixed-rate mortgages, rather than adjustable-rate mortgages.⁹ While the timing of this statement was terrible (abuses in the mortgage market were hitting their peak as lenders aggressively pushed unconventional mortgages), Greenspan's point was valid. For many homeowners, especially those who do not remain in their homes for long periods of time, a 30-year fixed-rate mortgage may not be the least expensive way to finance a home.

We know from the sizable jumbo market that existed before the housing crash that it would be possible for homeowners to get traditional 30-year fixed-rate mortgages even without the backstop of a government guarantee. However, it is certainly possible that the gap in costs would be larger between a traditional 30-year mortgage and adjustable-rate or shorter-term loans. If that proved to be the case, then more homebuyers would undoubtedly opt for these alternative mortgages. There is no obvious reason for this to be a cause for concern. While there may be a public interest in promoting homeownership, there is no public interest in encouraging homebuyers to waste money buying 30-year fixed-rate mortgages.

The Risks of the MBS Guarantee System

The basis for assessing the risks in the MBS guarantee system that would be established by proposals, including S.1217, is the system of private-issue mortgage-backed securities in the period before the collapse of the housing bubble. The main difference between the structures in place during the housing bubble years and the structure that would be created under such plans is that in the latter case there would be an explicit government guarantee. In contrast to the housing bubble period, investors will be assured that they will not be able to lose more than 10 percent of the value of their holdings in MBS due to mortgage defaults. This will amplify the moral hazard problem, compared to what existed in the bubble years.

⁹ Greenspan (2004).

While there have been some modest safeguards put in place as a result of financial reform regulation, there is little reason to have much confidence that these measures will prevent the sort of abuses seen during the bubble years. The measures that might have been expected to have the greatest impact in preventing abuses were beaten back or watered down in the rule-writing process.

For example, some proponents of stronger regulation of the MBS market have wanted securitizers to hold a substantial stake in every mortgage placed in a pool. This would provide them with a real incentive to ensure that only sound mortgages were placed in a pool. Fairly quickly the debate moved to the point that securitizers would not have to hold reserves against qualified mortgages with at least a 20 percent down payment. However, this provision was watered down to the point that securitizers need only maintain a 5 percent on stake on mortgages that are non-qualified or have less than a 5 percent down payment. The vast majority of mortgages that defaulted from the bubble years would have met these criteria.

A 5 percent down payment is a rather low bar for viewing a mortgage as safe. The default rate of mortgages with just 5 percent down has been typically been more than four times the default rate with mortgages of 20 percent or more down.¹⁰ Since banks can charge the same fees on these much riskier mortgages and pass most of the risk off to the taxpayers under plans such as S. 1217, it is reasonable to assume that they will take advantage of this opportunity. In other words, we can expect that banks will issue many mortgages that just meet the minimum requirements in these proposals to be placed in mortgage pools without requiring any interest by the securitizer.

It is also worth noting that even the 5 percent down payment may provide a misleading sense of security, given the uncertainty of appraisals. Even assuming no improper conduct on the part of appraisers, there can easily be differences of far more than 5 percent, based on totally honest appraisals. If a homebuyer initially fails to get a mortgage based on one appraisal, there is nothing to prevent him or her from seeking a second appraisal from a different lender. Given random errors in the process, if the true value of a home is anywhere close to allowing the homebuyer to meet the 5 percent down payment threshold with a given loan value, they will eventually be able to find an appraiser that gives a high-enough appraisal to meet the cutoff.¹¹

For example, if a homebuyer is prepared to put down \$10,000 on a home selling for \$200,000, he or she is likely to be able to eventually find an appraisal for \$200,000, even if the true value of the home is just \$190,000. This would mean that a mortgage issued for \$190,000 would in effect have zero equity on the day of issuance, even though it would be

¹⁰ Salmon (2011).

¹¹ Dotzour (1998) found a standard deviation of 10.0 percent in a sample involving appraisals done for corporate relocation firms in 1984-1986. This would imply a high likelihood that a mortgage that was effectively being issued for an amount at or above the true market value would receive an appraisal that showed the home to be worth at least 5 percent more than the amount of the mortgage.

reported as having the 5 percent down payment needed to allow it to be placed in MBS without requiring the securitizer to retain a stake.¹²

The other safeguard that could have placed a substantial check on the abuses of the housing bubble years would have been to take hiring decisions away from issuers in the selection of credit rating agencies. This would have removed the moral hazard problem that leads credit rating agencies to inflate their ratings in search of future business.¹³ This sort of rating inflation was a major problem in the housing bubble years, with an analyst at Standard & Poor's once complaining to a colleague that they would rate an issue even if "was structured by cows."¹⁴

There is little reason to believe that any changes in regulation will make the credit rating agencies more conscientious in the future than they were during the bubble years. In fact, the *New York Times* recently reported that Standard & Poor's appears to have deliberately lowered their standards for commercial mortgage-backed securities in an effort to gain business.¹⁵ If the private-issue market in MBS was to be revitalized by the guarantee provided by proposals such as S.1217, it is likely that Standard & Poor's and the other credit rating agencies will eagerly seek new business, even if this means competing by lowering standards.

Conclusion

The country has experienced an economic disaster as a result of a housing bubble fueled by irresponsible and fraudulent loans. The current system, in which Fannie Mae and Freddie Mac are effectively publicly controlled, provides an efficient and relatively safe way to support the secondary mortgage market. However, the system of government-guaranteed MBS laid out in many housing reform plans, including S.1217, would likely lead to the same sort of abuses that were seen in the private-issue market in the housing bubble years. However, this time the issuers would have the additional benefit of a government guarantee.

The most efficient solution would be to leave the current system of publicly run GSEs intact to sustain the secondary market. Given the enormous risks involved, and the limited potential savings to homeowners, the country would be much better served by simply taking the government out of the secondary market, rather than going the route of having the government guarantee privately issued mortgage-backed securities.

12 One of the authors' experiences with mortgage refinancing provide an interesting example of the variance in appraisals. An attempt to refinance in the fall of 2011 failed due to a low appraisal. Trying again in the spring of 2012, the new appraisal was 68.8 percent higher than the one given 6 months earlier. (There had been no substantive changes to the home in this period.) If the first appraisal reflected the true value of the house, then a 95 percent loan-to-value mortgage issued on the basis of the second appraisal would have been almost 40 percent underwater on the day it was issued. This is surely an extreme case, but it illustrates how the variation in appraisals could lead to many 95 percent loan-to-value mortgages being effectively underwater at the time of issuance.

13 Senator Al Franken proposed an amendment to the Dodd-Frank financial regulatory reform bill that would have given the Securities and Exchange Commission the authority to assign credit-rating agencies in order to avoid conflicts of interest. While this amendment was overwhelmingly approved by the Senate, it was stripped out in the conference committee.

14 Lucchetti and Burns (2008).

15 Popper (2013).

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