The B.E. Journal of Macroeconomics

Special Issue: Long-Term Effects of the Great Recession

Volume 12, *Issue* 3	2012	*Article 13*

Second Discussant Comment on "The Future of U.S. Housing Finance Reform"

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DOI: 10.1515/1935-1690.112

What are the likely long-term effects of the *Great Recession*? Clearly a changed housing finance system is one, although how the system will change in the long run is very much in question. The public debate is ongoing not only on what the new paradigm will be, but also on how we will get there. Swagel contributes to the discussion on both issues. Currently, we do have a new outcome, of course: the public option. With over 90 percent of financing for mortgages supported by public guarantees, we have federalized the housing finance system.[1] The public option is an outcome that is meant to be temporary, but as recent Congressional action to lift the FHA lending ceiling demonstrates, moving on is hard to do.[2]

Swagel argues for why it is both necessary and feasible to move on now by phasing out public sector funding and replacing it with new private sector funding. The long-run vision does not exclude an entirely private system. The article bases the argument for the proposed reform on clearly articulated principles that the new system is designed to serve. However, the desire to move on quickly runs up against a hard reality: the lack of an agreed-upon conceptual framework consistent with widely accepted goals that can be quickly put into place.

Whether in fact a quick transition is feasible and whether Swagel's long-term vision achieves the goals set forth, particularly in comparison with other alternative conceptual frames, are both in question. Overall reform proposals can be classified into three categories: securitization with government guarantee (SGG), securitization in the private sector (SPS), and a public utility cooperative (PUC).

The system proposed includes both a government backstop (in the short and intermediate run) and private capital. In the short-to-intermediate run, multiple firms securitize qualifying mortgages with government guarantees. Private capital takes the first-loss position. Government support goes specifically to the MBS instead of the institutions themselves, thereby allowing institutions to fail. For Swagel, it is important that there be multiple firms, since reducing firm size and increasing their number solves the "too big to fail" problem, thus removing the moral hazard imposed on taxpayers by undue risk-taking. Also, he points out that the institutions compete for market share, eliminating excess profit.[3] The government backstop brings private capital back into the system, and Swagel's vision includes the eventual possibility of a fully privatized system.

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1 With the conservatorship and bail-out of the GSEs, most funding for mortgages currently comes from Fannie Mae and Freddie Mac, with 30 percent guaranteed by the Federal Housing Administration (FHA).

2 An increasing share going forward is likely to derive directly from the FHA, especially with the recent Congressional action to increase the FHA's loan size limit to $729,750, exceeding that of the GSEs for the first time in history.

3 Assuming the guarantee fee is correctly set, not only will this benefit be passed along to borrowers, but it will solve the allocative efficiency problem of too much capital provided to housing due to subsidized finance. However, the question of what is the appropriate insurance fee is a large one.

At first, the government sells an explicit guarantee on conforming MBS issued by all private firms. Over time, private take-up reduces the necessity for Fannie and Freddie. Then, the price of insurance is increased and the quantity of government guarantees shrinks, until eventually the insurance is auctioned to the private sector.

As Swagel notes, the system he proposes is consistent with the third proposal outlined in the Treasury Department and the U.S. Department of Housing and Urban Development's 2011 White Paper on options for the future of housing finance, "Reforming America's Housing Finance Market: A Report to Congress." In that paper, the SGG option is opposed to a fully private system or a public system that is propped up when the market is destabilized. The proposed system is also very similar to another SGG proposal, the Housing Finance Reform Act of 2011, introduced in the House by Representatives John Campbell and Gary Peters (Campbell and Peters 2011). This bill, H.R. 1859, instructs the Federal Housing Finance Agency to wind down Fannie Mae and Freddie Mac. Simultaneously, it creates privately capitalized "housing finance guaranty associations," which would securitize mortgages and would qualify for a government guarantee as "Federal Housing Finance Agency (FHFA) securities," in exchange for an annual fee.[4]

There is, however, an alternative public utility co-operative (PUC) solution. A vision of a reformed housing finance system based on this alternative is described by researchers from the New York Federal Reserve (see Dechario et al. 2011). This proposal would create a mutually organized lender cooperative consisting of member entities that securitize standardized residential mortgages, with the government only responsible for tail risk through a reinsurance fund. Representatives Gary Miller and Carolyn McCarthy recently introduced a similar proposal, the Secondary Market Facility for Residential Mortgages Act of 2011, H.R. 2413 (Miller and McCarthy 2011), which would create a public utility financed by private capital.[5] The conceptual frame arguing for this approach alleges that the problem was created by a race to the bottom by many competing institutions in the absence of surveillance.[6]

[4] The Campbell-Peters bill does not prescribe specific terms for mortgages to qualify as FHFA securities; rather, it tasks the FHFA with creating one or more standard forms that regulate the terms of such securities. This bill is similar to the proposals put forward by the Mortgage Bankers Association ("MBA's Recommendations for the Future Government Role in the Core Secondary Mortgage Market" [Council for Ensuring Mortgage Liquidity 2009]) and the Center for American Progress ("A Responsible Market for Housing Finance" [Mortgage Finance Working Group 2011]), though there are differences regarding the provisions for affordable housing and access.

[5] The Miller-McCarthy bill is similar to the proposal released by the National Association of Realtors, "Recommendations for Restructuring the GSEs" (2011).

[6] Most recently, another bill introduced by Senator Johnny Isakson takes a similar approach of combining Fannie and Freddie into a government-owned corporation. This bill differs from the Miller-McCarthy proposal, however, in that it envisions that this corporation would be privatized in ten years (Isakson 2011).

Besides these two proposals in Congress, there legislation has been introduced to simply shut down the GSEs over time—H.R. 2889, the GSE Bailout Elimination and Taxpayer Protection Act, introduced by Representative Jeb Hensarling—and two alternative proposals that mandate purely private systems with limits on what can and cannot be securitized. These bills, the Private Mortgage Market Investment Act, drafted by Representative Scott Garrett, and the Residential Mortgage Market Privatization and Standardization Act (S. 1834), introduced by Senator Bob Corker, wind down the GSEs over several years and simultaneously prescribe specific regulations regarding transparency and standardization in the private securitization process.[7]

In arguing for the SGG model outlined here, Swagel sets a foundation for the goals that a housing finance system should achieve.

1. Support homeownership (with long-term fixed rate mortgage financing).[8]
2. Protect taxpayers.
3. Protect the financial system and the economy against systemic risks.
4. Clarify the roles of the private and public sectors.
5. Foster competition and innovation.
6. Provide continued public support for affordable housing (although as Swagel points out, this is not the focus of the paper).
7. Arrive at a housing finance system that can remain stable over time.

We can summarize these goals under two basic principles: support homeownership and protect the financial system (and therefore the taxpayer). Unlike many commentators, Swagel argues that homeownership should be supported both because of its importance to American families and its centrality to the economy. Owing to this importance, he predicts that the government "will intervene if potential homebuyers cannot obtain mortgage financing." He asserts that the depth of the financial system's exposure to the residential mortgage market will force policymakers to act in future crises, implicating the taxpayer if the system fails. Therefore, firms should pay for insurance. Taxpayer protection is not achieved by pushing the federal government out of the housing finance system, in the sense that no bail-out, or at least support of housing finance, will be provided in a crisis. Such a promise is not credible in Swagel's view.

7 The importance of the TBA market is acknowledged in both of these legislative proposals, which assert the need to maintain and support this market. At the same time, they withdraw both the "skin in the game" and the QRM and QM offered in the Dodd-Frank bill. Also see White and Wilkins (2011), which argues for no federal presence in multi-family housing finance.

8 Swagel mentions that it is desirable to specifically support long-term fixed rate loans without explaining why it is desirable. Yet this availability is necessary for having a securitized housing finance system. Otherwise, the discussion should be about how to make bank lending to the real estate sector less subject to cyclical swings.

For Swagel, the key protection for taxpayers is solving the too-big-to-fail problem by setting up numerous SGG firms. The core question for him is: what system will support both homeownership and protect taxpayers? For Swagel, both of these goals can be achieved if failed firms can be put into bankruptcy before they call upon taxpayer resources.

If the source of the collapse of housing finance were the too-big-to-fail problem, then this could work. But the problem that led to the crisis was a system failure, with many firms failing at the same time: the implosion of multiple lenders and private label securitizers and the failure of the GSEs. Competition among smaller entities alone does not solve this problem. Fundamentally, this is an insurance market and an insurance rate war is not a desirable outcome.

The issue of transition is also related to the question of what both protects taxpayers and supports homeownership. The article assumes that at least some private capital is ready to step up now at reasonably competitive rates to fund mortgage finance through securitization and to take on the risk of market instability. However, in the large segment of the market where Fannie and Freddie cannot operate, there is little private label securitization. Securitization has come back to credit cards and, to a lesser extent, commercial MBS (Levitin and Wachter 2012a); meanwhile, securitization has not come back to residential MBS.[9]

But this question has implications both for the immediate situation and a future crisis. To support a market collapse in the future, what would be done in the Swagel proposal? Presumably the FHA or the Federal Reserve System would become the buyer of last resort. Both of these solutions entangle the taxpayer. Government insurance, together with private financing by competing firms, is likely to be subject to cyclical pressures. Just when the system needs funding, the risks may be perceived as too high. What exacerbates this cyclicality is the production of underpriced credit in the expansion phase of the cycle, followed by re-priced credit or no credit in the downturn. The problem of mispriced credit expansion is likely to be accompanied by deteriorated underwriting standards, if uninformed investors supply credit to securities markets or to banks.[10] The paper is silent on how to prevent this.[11]

In order to avert system failure and taxpayer rescues, this instability needs to be addressed. The system, not just institutions that were too big to fail, collapsed.

9 See, for a discussion, the testimony of SIFMA representative Richard A. Dorfman before the House (Dorfman 2011).

10 The credit quality deterioration may spur higher prices, which hides the fact that the book of business produced is of lower quality and likely to be subject to higher credit risk. Evidence that subprime credit expansion produced temporarily higher prices is found in Pavlov and Wachter 2011.

11 The evidence is that credit rating agencies, which served as the third party risk validators, are not in a position to prevent this. Ratings appear to have depended upon market prices; see Owusu-Ansah 2011.

Although moral hazard and expectations of bailouts contributed, many financial institutions, small and large, failed and their interconnections and the threat of contagion (Anand et al. 2011) led to the call for intervention. Systemic risk was the outcome of procyclically produced risk by many institutions and itself was the outcome of a lack of market surveillance, discipline, and accountability by investors and regulators. Reliance on the public option after the failure of a system including private and public entities is a repeated outcome in U.S. history (Levitin and Wachter 2012b). We will need to place more emphasis on surveillance and accountability to prevent this outcome.[12]

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[12] This issue is beginning to gain traction in policy discussions, where the necessity of a standardized, transparent private market is becoming better understood. This can be seen in the bills introduced by Representative Garrett and Senator Corker, which, as noted, prescribe regulations regarding transparency and standardization in the securitization process.

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