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Privatizing the Housing Finance System

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Privatizing the Housing Finance System

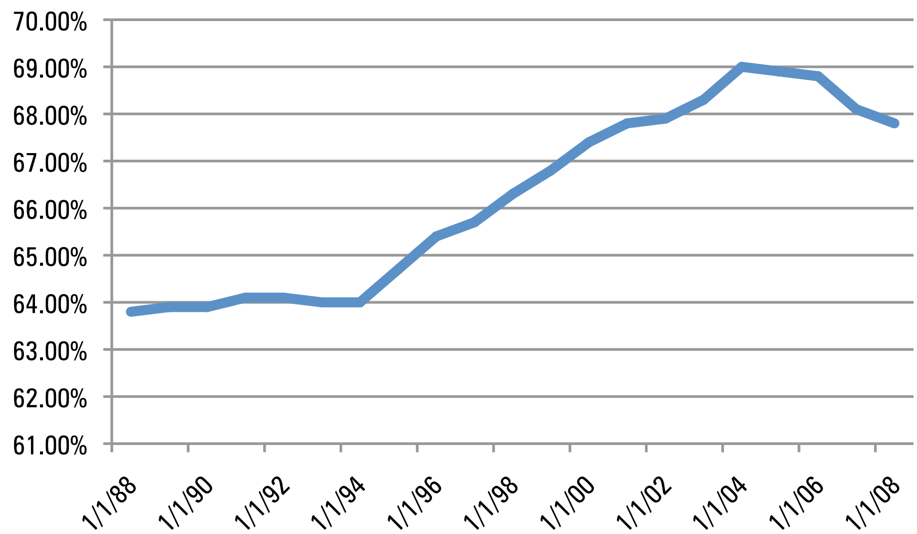
Since the credit crunch began in 2007, private sector financing for residential mortgages has been virtually non-existent. At the end of 2010, government-backed organizations—including Fannie Mae, Freddie Mac and the Federal Housing Administration (FHA)—were financing more than 90% of all mortgages in the U.S. In addition, the federal government has been using both fiscal policy and monetary policy to increase liquidity for home purchases, put downward pressure on mortgage interest rates and boost housing values. However, the various federal programs have only served to provide temporary relief from falling housing prices, delaying the necessary clearing of surplus homes in the marketplace. The programs of the past three years have continued decades of federal housing policy that ultimately created a very unstable market.

There is widespread consensus that the current system is unsustainable. Even long-time supporters of Fannie Mae and Freddie Mac, such as Rep. Barney Frank (D-MA) have conceded that the government-sponsored enterprises (GSE) need to be dissolved. However, there is a growing argument from a range of "interest" groups proposing that federal intervention and guarantees of some kind are necessary for the future of housing finance. This is far from true. Prior interventions and guarantees have a checkered past that leaves no doubt that such proposals will once again privatize gains and leave the taxpayers with the losses. The most logical path forward to a sustainable housing market is a complete privatization of the housing finance system.

A. The Last Two Decades of Housing Policy in Brief

It has long been the common belief in Washington that promoting homeownership is good politics. The chartering of Fannie Mae in 1938 and the passage of the Community Reinvestment Act of 1977 (CRA) were both designed to provide liquidity and incentives for mortgage lending. And from the 1960s to the mid 1990s, the homeownership rate stayed in a relatively stable range of 62% to 64%. Housing policy took on a new form, though, under the guidance of Housing and Urban Development (HUD) Secretaries Henry Cisernos (1993 to 1997) and Andrew Cuomo (1997 to 2001). The result of their policies, which were continued with gusto by the Bush administration, was a radical jump in the homeownership rate from 64% to 69% between 1995 and 2005, the peak of the boom (see Figure 1).

Figure 1: U.S. Homeownership Rate from 1988 to 2008



Source: U.S. Census Bureau

This may sound like a positive outcome, but the rapid growth in homeownership would prove unsustainable and has ultimately led to the foreclosure epidemic currently besetting the housing market.

One of the first major changes to promote this growth in homeownership was the Affordable Housing Initiative in the early 90s, setting out the goal of making alternative mortgage financing more readily available to low-income families. As a part of implementing the Affordable Housing Initiative, Congress passed a bill that completely updated the Community Reinvestment Act, placing more emphasis on performance-based evaluations that allowed regulators to essentially blackmail certain banks into lending (often described as "quantifiable outcomes").

In order for the banks under CRA to comply with new regulatory requirements they designed innovative lending options, such as interest-only mortgages, principal-only mortgages, and an array of adjustable-rate mortgages. Even the banks that weren't regulated by CRA developed the same products in order to compete. Quickly, borrowers with unstable credit began to find it easier and easier to obtain a mortgage. The result was a greater proportion of the population entering the housing market than was previously possible or than would have been anticipated based on normal economic and population growth trends. And with that increase came a substantial rise in prices.

While the CRA was decreasing lending standards for certain banks in the private sector, HUD directed Fannie Mae and Freddie Mac to lower their lending standards as well. As a part of the Affordable Housing Initiative, HUD Secretary Cisernos began increasing the affordable housing mandates for Fannie and Freddie. At that time, the GSEs were required to have 30% of their loan purchases contain mortgages issued to individuals or families under the median income in their area. In 1996 this quota was increased to 40%. In 1997, Secretary Cuomo increased the number to 42%, and then to 50% by 2001. According to George Mason University economist Russ Roberts, under the Bush administration HUD continued increasing the affordable housing goal of the GSEs up to 52% in 2005 and 53% in 2006. By the time the housing bubble was beginning to pop in 2006, Fannie and Freddie were required by HUD to have 55% of the loans they bought be mortgages issued to low-income borrowers.

Since their inceptions, Fannie Mae and Freddie Mac have had specific guidelines as to what kind of mortgages they can buy from the private sector. Specific aspects of a loan's down payment percentage, borrower credit history and other measurements determined whether a mortgage "conformed" to GSE standards. However, in order to meet the HUD affordable housing requirements, Fannie and Freddie had to lower their conforming loan standards. This meant the quality of mortgages on the government-sponsored enterprises' books dramatically decreased at the same time that the growth of the housing bubble increased the number and dollar amount of mortgages they took on.

As Fannie and Freddie decreased their conforming loan standards, it created a market for mortgages with increasingly higher loan-to-value (LTV) ratios. Prior to the HUD rule changes and CRA update, a minimum loan-to-value (LTV) ratio of 80% at the time of the origination of the mortgage was typical. This meant that at the time of purchase, a homebuyer was putting up 20% of the home price as a down payment and borrowing the remainder. But as seen in Table 1, loan-to-value ratios jumped an overall rate of seven percentage points during the housing bubble. LTV rates on second mortgages grew even faster. (Second mortgages, or second liens, are essentially loans taken sometime after an initial mortgage—often coming in the form of a home equity line of credit—that hold secondary priority in the event of foreclosure. Whoever holds the first mortgage has the right to be paid back in full from any recovered funds in a foreclosure proceeding, with whatever remains to cover repayment to the lender of the second lien.)

Table 1: Characteristics of Subprime Loan Originations

Year of Origination	Cumulative LTV	Silent 2nd Lien
1999	78.8	0.5
2000	79.5	1.3
2001	80.3	2.8
2002	80.7	2.9
2003	82.4	7.3
2004	83.9	15.8
2005	85.3	24.6
2006	85.5	27.5

Source: Federal Reserve Bank of New York

With Fannie Mae and Freddie Mac expanding their low quality mortgage purchases to meet affordable housing goals, the banks stepped up to meet the demand. Banks found that they could originate mortgages with high LTV ratios to borrowers with lower creditworthiness and borrowers who had limited credit histories—a.k.a. subprime mortgages—and simply sell the risk to the GSEs seeking to meet their goals. This allowed banks to offer mortgages with lower interest rates, spurring demand from buyers. That demand drove up prices, requiring the GSEs to pump more liquidity into the marketplace to push down mortgage prices to affordable levels, which simply began the cycle again.

The whole system exploded at such a rapid pace that banks forgot the housing market could not grow forever. The originators collected high fees for issuing the subprime debt, but didn't have to deal with the risk of a default. Laws that allowed for banks to operate with more regulatory freedom failed to add incentives for risk takers to watch their actions, leading to the too-big-to-fail moral hazard mentality. Lenders wheeled and dealed at such a frantic pace that banks are now struggling to find all the paperwork associated with their toxic loans as foreclosures have flooded Wall Street. But by the time the music stopped there were 27 million subprime and Alt-A mortgages in bank portfolios and securitized for investors. And of these low-quality mortgages about 71% were supported by the GSEs, FHA, CRA banks and others with government backing.

B. Post-Bubble Policies Continue the Trend

The credit crunch of 2007 threatened homebuyers with extremely high mortgage rates, given the lack of money available for lending. Many subprime borrowers with teaser rates needed to refinance every few years to avoid having their mortgages reset at high, unaffordable rates. As the credit crunch cut off refinancing opportunities it turned into the subprime foreclosure crisis. And this posed a significant problem for the government's homeownership policies. As Treasury Secretary Henry Paulson said in a July 2008 speech, "Turning the corner on the housing correction requires homebuyers to return to the market, and homebuyers need available and affordable mortgage financing." Even though by then it was clear Fannie Mae and Freddie Mac had played a substantial role in flooding the market with toxic mortgages, Secretary Paulson also argued, "The GSEs are providing an essential function."

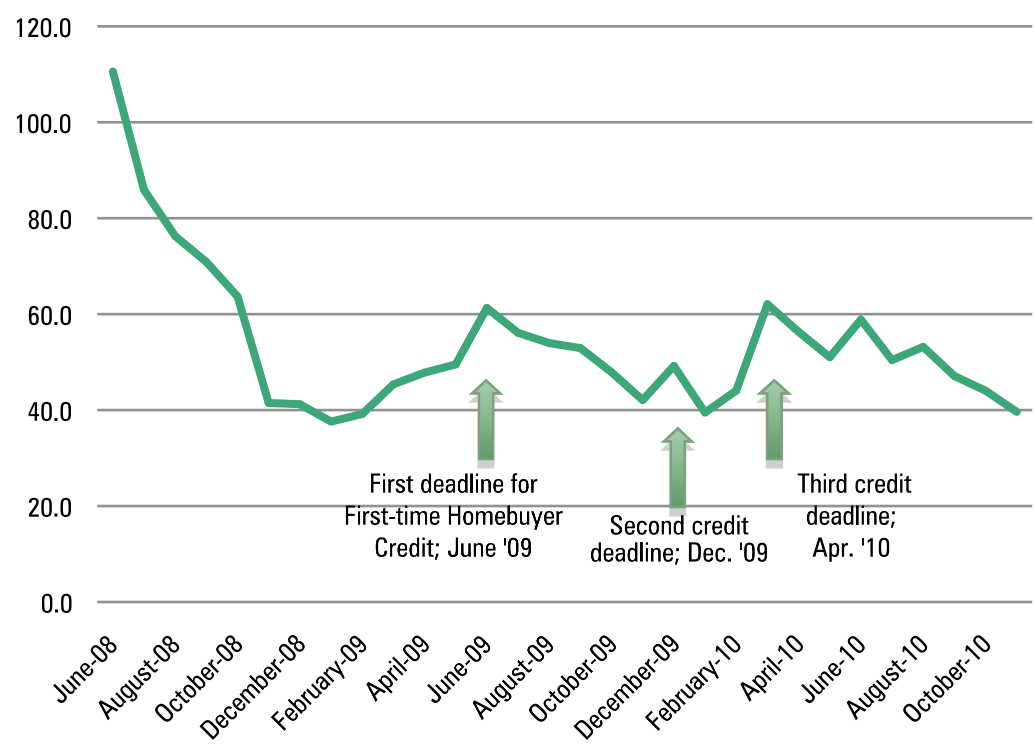
The Bush administration began a series of programs, continued and expanded by the Obama administration, aimed at pushing down mortgage rates and incentivizing homeownership. The government believes that by making home purchases more affordable, homebuyers will push the housing market out of its slump. As Secretary Paulson said: "The sooner we work through the housing correction, the sooner home prices will stabilize, and uncertainty about the values of mortgage-related assets will be more easily determined. So now, more than ever, we need Fannie and Freddie out there, financing mortgages."

The results of the government's efforts have been mixed, depending on the measure of success. The Treasury Department and Federal Housing Finance Administration (FHFA) have been aggressively using Fannie Mae and Freddie Mac to fund the market. This financing has helped push mortgage rates to record lows, which has in turn provided a strong incentive to buy a home or refinance. The government has sought to incentivize homeownership in other ways as well, including the First-Time Homebuyer Credit and the Federal Reserve's program to buy toxic debt from the GSEs in order to help keep mortgage rates even lower. For those looking to refinance, government has offered a series of programs under its Making Home Affordable banner. These programs have included modification and refinancing options subsidized by the government.

C. New Programs Fail to Generate Sustainable Growth

None of these programs has done much to promote sustainable housing growth, however. The First-Time Homebuyers tax credit caused a jump in home purchases each time it was set to expire, but it appears that the demand created was simply stolen from the future. Figure 2 shows the rate of applications for residential building permits declining in 2008 until the tax credit for buying a new home was established by the Housing and Economic Recovery Act of 2008 began to take effect. Building permits began to pick up in earnest in 2009 with the deadline for the credit set to expire. Those applying to build a new home dropped off after each deadline to qualify for the credit, but picked up with each deadline extension. The declines demonstrate that demand was artificially created and unsustainable. At the end of 2010, building permit requests were near historic lows.

Figure 2: Number of Building Permits Requested (in thousands)



Source: U.S. Census Bureau

The Federal Reserve and Treasury purchased $1.5 trillion in debt from Fannie Mae and Freddie Mac with the intention of helping the GSEs provide liquidity to the mortgage markets and to decrease the rate of interest on mortgages to unfreeze these markets. As the Federal Reserve Bank of New York says, "The goal of these purchases… is to reduce the cost and increase the availability of credit for the purchase of houses." In one sense, this program has been a success. The GSEs have continued funding mortgages and rates have stayed at historical lows. However, these artificial lows have prevented housing prices from reaching their true bottom to restart stable growth. Furthermore, while trying to help homebuyers with low mortgage rates, the Fed program has hurt them by encouraging higher home prices.

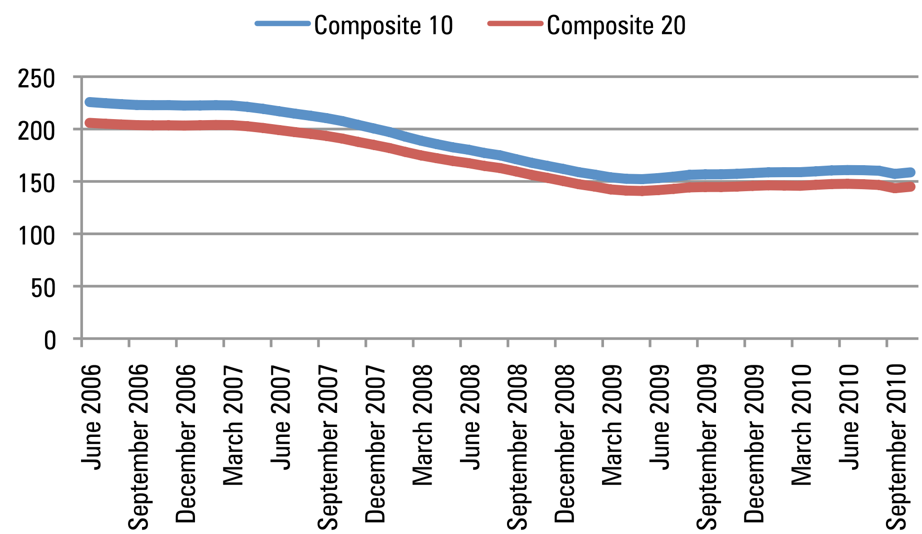
The government has also attempted to support the housing market by providing programs to prevent foreclosure and help homeowners afford their mortgage payments. The Home Affordable Refinancing Plan (HARP) aimed to give up to four to five million homeowners with loans owned or guaranteed by Fannie Mae or Freddie Mac an opportunity to refinance into more affordable monthly payments. However, this program has largely failed because those who took on unaffordable housing payments are unlikely to have the cash on hand necessary for refinancing, which generally requires putting equity into a home in order to push down its loan-to-value ratio. And only roughly 1% of mortgages refinanced through the program went to homes with LTV ratios over 105%, the real target of the program's attempt to fight off negative equity and prevent payment problems.

The Home Affordable Modification Program (HAMP) committed $75 billion to keep up to four million Americans in their homes by modifying delinquent mortgages and preventing "avoidable foreclosures." Several thousand mortgages were modified through the program in its first year, but nowhere near a significant enough number to impact the negative equity problem in the housing market. Furthermore, between 70% and 80% of those modified mortgages slipped back into delinquency within six months.

D. The Results of Failed Federal Housing Programs

The unfortunate result of the various government programs aimed at stabilizing the housing market and boosting homeownership has been nearly the opposite of intended. At the beginning of 2011, the American housing market remains very weak. Even with the programs incentivizing homebuyers to purchase now, housing price gains have been minimal. According to the Case-Shiller price index, housing values hit bottom in the first quarter of 2009, but they only bounced up 4% by the end of the year. And prices already began to slump again in 2010 in the wake of the tax credit expiration (see Figure 3). The rest of the gains will likely disappear over the next six to twelve months unless another program is instituted to prop up prices, perpetuating the artificial market that stands in the way of recovery.

Figure 3: S&P/Case-Shiller Housing Index June 2006 to October 010 (Seasonally Adjusted)



Source: Standard &Poor's/Case-Shiller

The most significant problem with the government's programs is the way they have slowed the realignment of the housing market. One of the reasons the housing bubble popped was that the supply of homes being built began to outpace demand. With more homes on the market, prices began to fall, exposing subprime mortgages and homes with little equity built in to severe delinquency problems. According to data from the Mortgage Bankers Association, delinquencies have been climbing at a steady rate since 2007, only beginning a sustained pattern of decline in the third quarter of 2010. And while the rate of foreclosures slowed down for the first time since 2007 in the third quarter of 2010, it was largely due to the robo-signing scandal forcing banks to reassess their foreclosure processing procedures. In fact, RealtyTrac.com reports that November 2010 marked the 21st straight month of more than 300,000 foreclosure filings.

Meanwhile, the government-subsidized low mortgage rates available have encouraged many to refinance, but the additional subsidy provided by HAMP and HARP has only delayed the inevitable need to foreclose. And that means that even with the foreclosure rate as bad as it is, the number should be higher. Combined with occasional foreclosure moratoriums by institutions or in certain areas and the high volume of defaults overwhelming delinquency processing units, there is a growing "shadow inventory" of homes. This inventory consists of homes that should be in foreclosure and available for a bank-owned sale. In November, CoreLogic reported that the shadow inventory had jumped 10% in 2010 to 2.1 million homes.

Keeping these homes off the market does two things. First, it distorts the supply and demand influence on prices. With more homes available, prices would be pushed lower. This would make negative equity problems worse, but it would also properly align the actual supply and demand for homes in America, allowing for a housing recovery to be built on a more stable foundation. Second, it drags out the pace that foreclosed homes hit the market, making the recovery process longer and more lethargic. It would be preferable to work out problems in the housing market sooner than later so that the economy can recover more quickly and thoroughly.

E. Building a Stable and Sustainable Housing Market

In order to build a sustainable housing market with stable growth, the housing finance system will need to be reformed. This overhaul process will have three components. The first is Fannie Mae and Freddie Mac reform. The second is fiscal policy reform on housing matters. And the third is developing a new regulatory framework to replace the outgoing system, including FHA reform. This process will be picked up and debated by the new 112th Congress.

GSE Reform: There is overwhelming support for a massive overhaul of Fannie Mae and Freddie Mac in all political camps. Their role at the heart of the housing bubble and subsequent crisis make the necessity of reform unmistakable. The question is how and when to move forward.

Dissolving Fannie Mae and Freddie Mac will be a complicated, but manageable process. Treasury Secretary Timothy Geithner testified in April 2010 that because Fannie and Freddie were so critical for the housing market today they should be left alone until the housing market recovers. The problem is that this means a "recovery" will be built on the same artificial and unstable foundation as the pre-crisis housing market. The second price bubble in housing is only creating more problems down the road.

Rather than wait and build an unstable housing recovery, GSE reform should begin now. One way to start the dissolution of Fannie Mae and Freddie Mac would be to reduce the conforming loan limits—currently $417,000 for standard conventional loans and $729,750 for so-called high cost living areas. This could be done over a three- to five-year window, phased down a certain amount each year until the GSEs no longer are able to finance mortgages. With the role of the GSEs in financing the market progressively wound down, the process of divesting GSE assets would begin.

All assets and obligations of the GSE would be sold by a specific set date. The size of the mortgage portfolio could be reduced by a certain percentage, such as 10% from the original amount each year (regardless of runoff) for four years and then 15% a year after that for a maximum of an 8-year wind down. Another idea would be to have Treasury buy the GSE's existing mortgage portfolio of about $1.6 trillion (all in the form of MBS "guaranteed" by the GSEs) and also assume the GSE debt funding this portfolio (purchased at par and placed into a separate liquidating pool). This could help achieve substantial savings for the taxpayers since future GSE financing needs—while they are wound down—would be provided by U.S. Treasury debt, which is roughly 25 basis points cheaper than borrowing rates currently available to Fannie and Freddie.

There are other components of GSE reform that could be considered by policymakers in the coming years as well, both as accompanying policy changes to a wind down of Fannie and Freddie or as alternative ideas if substantive reform is political untenable. First, abolishing affordable housing goals for the GSEs while they stay in business, as well as for all other housing agencies, is a must. Second, putting the employees of Fannie and Freddie on federal payrolls would acknowledge their real function as an arm of the government, and the reduced compensation would encourage the staff of the GSEs to promote privatization efforts to be out from under the government's thumb. Third, Congress could increase the capital requirements of the GSEs so that their capital ratios treated debt and MBS more like private sector companies. Fourth, all remaining stock in Fannie and Freddie could be wiped out and the GSEs put on the federal budget. This would put an end to the government-sponsored enterprise model and harden the Treasury guarantee of GSE losses. Fifth, begin increasing the underwriting standards of loans purchased by the GSEs so that downpayments get to 20% (or 10% with private mortgage insurance). Finally, at the very least, Congress should require that Treasury exercise its authority to approve or disapprove all debt issuance from the GSEs so that there is additional transparency in the actions of Fannie Mae and Freddie Mac.

[For more detailed ideas on GSE reform, see Reason Foundation's "Near-term Ideas for Mortgage Finance Reform" at http://reason.org/news/show/mortgage-finance-near-term-reform]

Fiscal Policy Reform: The government artificially distorts mortgage prices by a range of fiscal policies from tax law to Federal Housing Administration loans. First, the tax code incentivizes owning a home by making mortgage interest payments deductable. Interest on loans backed by up to $100,000 of home equity, no matter what the loan is used for, is also deductable from income tax returns. This creates an incentive to invest in homes in order to get the tax break, as opposed to potentially investing elsewhere.

Second, home sellers have been able to largely avoid paying capital gains taxes since 1997. Regulations restrict this capital gain exemption to once every three years, but there are exceptions even for this rule. In theory, reduced capital gains taxes would be positive for economic growth. However, this is problematic because it creates an exemption that unnaturally incentivizes investments in housing and distorts the natural flow of resources.

In order for the housing market to grow without artificial support from the government, these tax advantages for homeownership will have to be repealed. These combined distortions put upward pressure on the price of housing, increasing the value of homeowner investments in housing. However, the unnatural price support attracts resources away from other possible investments, creating bubbles and slowing the growth of other industries, while also pricing lower-income buyers out of the market.

A New Framework: With Fannie Mae and Freddie Mac dissolved, and federal subsidies and tax favoritism repealed, a large hole will open in the housing market and most federal subsidies for housing will be shifted to the Federal Housing Administration. As such, it is critical to note that Congress cannot dissolve the GSEs without at the same time addressing changes for FHA. Without proper reform affordable housing lending will shift over to this agency within HUD and begin repeating the mistakes of the past.

It has now become universally accepted that it is not a good idea to push people into homes they cannot afford. FHA (and others) should only encourage homeownership that is sustainable for the homebuyer. But assuming Congress will continue to support subsidizing at least very low-income housing as a social policy choice through FHA, any subsidies should be direct to the borrower, on-budget and subject to appropriations, narrowly targeted so as not to compete with the private sector, governed by accurate accounting methods, and built on sustainable underwriting standards.

Congress could pursue a number of possible policy changes. One suggestion would be to develop underwriting standards so that the probability of loss for FHA on a mortgage default is no greater than five times that of a loan to a highly-qualified borrower on a single-family purchase mortgage making a 20% down payment. Another, congruent idea is to have FHA mirror the standards in place for rural housing programs by limiting mortgage sizes to 100% of median housings values as measured on the local level and cap the income of a FHA loan recipient at 80% of local median income. FHA could also require lenders to repurchase any loan in which the borrower misses three consecutive payments within the first 24 months of the loan. It might also encourage more skin in the game for lenders by moving away from the 100% guarantees as currently offered, even if the move is small.

For the rest of the market, mortgage lending may shift significantly. For decades, the market has been dependent on the GSEs for liquidity, and without this support, the private sector will have to gradually move into the secondary mortgage market.

The government can have a role to play, in both ensuring fair competition in the mortgage market and using legislation to make mortgage-financing innovation easier and more lucrative. Specific innovations cannot be decided on ahead of time by policymakers; they must be organic and develop where there is a market for them. But policymakers can design rules and regulations to encourage private capital as the sole source of mortgage financing when the ideas surface.

One example is covered bonds, an alternative to mortgage-backed securities, which packages mortgages into bonds (instead of securities), with cash flows from mortgage payments going to the bondholder. What makes a covered bond unique is that the originator holds the originated mortgages on its books and guarantees them with other assets on its books. The model requires originators to have a vested interest in the health and stability of the loan, instead of the originate-to-distribute model that plagued the industry during the house boom.

The government can also have a role in promoting transparency and prosecuting fraud. The more consumers know about the firms they are borrowing from, the better consumers will be at selecting quality products and the more businesses will seek to provide quality service. Furthermore, claims of fraud or dishonesty should be pursued with greater vigilance to create an expectation of enforcement. Regulators should leverage the importance of business reputation. If a particular firm were constantly under investigation for fraudulent businesses practices, that would certainly hurt its profit margin and thus create incentives to be more honest with high service quality.

Incentivizing consumers to educate themselves would go a long way to avoid a host of problems in the future. Buying a house is a big deal, and consumers should take the time to understand what they are buying. It is not unreasonable to believe that if a consumer does not want to take the time to understand his mortgage, he may not be ready for homeownership. Firms cannot deceive or abuse prepared consumers. Perhaps the best way to do this would be to remove safety nets for consumers by reducing their recourse to prosecute lenders. If consumers knew their options would be limited if their investments went bad, they would have more incentive to learn about the mortgages they are taking out.

F. Conclusion

Building a sustainable housing market means pure private sector financing, and no federal subsidies skewing the supply and demand incentives of lenders or buyers. Such a market, coupled with a regulatory framework that removes barriers to mortgage lending and financial innovation, would help the housing market grow with stability. It would also, however, look very different than the market today.

In order for a privatized housing finance market to work, the government and the American people will need to change the way homeownership is perceived. For decades homeownership has been held up as a universally wise investment strategy, synonymous with the American Dream. Yet, the 21st Century is changing this reality for the United States. As American society has become more mobile, investment in fixed assets has become less attractive. The returns on the investment are in decline, and the ways homeownership can stagnate a society are surfacing in new and more convincing ways.

This is not to say that homeownership is a bad thing. Rather, homeownership is no longer assumed to be inherently a good thing for all people. As such, the main goal of reform should be to shift the mindset of policymakers from promoting affordable housing to promoting real wealth-building. Building wealth is not an easy thing to do. It requires hard work, discipline, thrift and personal responsibility. Homeownership may or may not be a good tool for building wealth, depending on the individuals involved, the geographical location of the home, employment status and available cash for a down payment. Ultimately, with an economy and population as diverse and dynamic as the United States, the government should realize it should not try to use policy as a means of promoting any societal aim—even homeownership.

The role of government should be to support a sustainable regulatory structure for the private sector financing of mortgages. Federal involvement in housing finance ultimately distorts the market by placing unnatural upward pressure on home prices and downward pressure on mortgage yields. This isn't a stable system that benefits taxpayers in the long run. A reformed housing finance regulatory structure should be used to align business and consumer interests more acutely, prevent fraud and ensure the market is a just field for competition.

A key step in the process of reform will be dissolving Fannie Mae and Freddie Mac without replacing them with another market-distorting housing agency or similar explicit guarantee for mortgage financing. The resulting change will require a significant shift in the way of thinking about housing finance. The new market will be different than yesterday or today's housing market. Mortgages may not be as readily available as before, and prices will likely be different. But the goal shouldn't be to return to the market conditions of the bubble. That is unsustainable. Instead, the focus should be on building stable wealth over a long period of time while avoiding policies that distort the market and lead to calamitous results.

For More Information

- Testimony of Anthony Randazzo Before the U.S. House of Representatives Committee on Finance Services Subcommittee on Capital Markets and Government Sponsored Enterprises on Feb. 9, 2011 at http://reason.org/news/show/housing-finance-reform-testimony

- Reason Foundation, *Ten Arguments Against a Government Guarantee for Housing Finance* at http://reason.org/news/show/housing-finance-reform

- Reason Foundation, *Rethinking Homeownership: A Framework for 21st Century Housing Finance Reform* at http://reason.org/news/show/rethinking-homeownership-a-framewor

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