The Role of Government in the Housing Finance Market

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Tom Heintjes: *Welcome to the Federal Reserve Bank of Atlanta's* Perspectives on Real Estate *podcast series. I'm Tom Heintjes with the Atlanta Fed.*

Today, we're talking with Larry Wall, a research economist in the Atlanta Fed's research department. Larry is a coauthor, along with Scott Frame and Lawrence White, of a paper titled "The Devil's in the Tail: Residential Mortgage Finance and the U.S. Treasury." His paper discusses the role of the government in the housing finance market.

Larry, thank you for joining me today.

Larry Wall: Thank you for inviting me, Tom. I'm very happy to be here.

Heintjes: *Larry, let me start by asking you, when and why did the federal government assume a role in mortgage finance? And, in your view, is it playing the right role?*

Wall: Well, Tom, the federal government has a long history of encouraging homeownership by lowering the cost of debt financing. Among the more important support measures have been—in the 1930s, the creation of a number of agencies including the Federal Home Loan Banks, a deposit insurer for thrifts, the creation of the FHA [Federal Housing Administration] and of the Federal National Mortgage Association, now known as Fannie Mae. In 1944, the government started giving guarantees on 50 percent of mortgage loans for returning veterans. Then, Fannie Mae was privatized for budget reasons in 1968, but then the government created the Government National Mortgage Association to securitize FHA and VA [Department of Veterans Affairs] loans. Freddie Mac was created in 1970. And, while prior to 1986, individuals could deduct interest payments on all loans from taxable income for federal taxes, including mortgage interest, the Tax Reform Act of 1986 eliminated this deduction for almost all personal loans, but the mortgage interest remained tax-deductible, giving mortgages a privileged access to the market.

In more recent times, the primary rational has been to encourage increased homeownership. Yet, as Mark Calabria pointed out in his discussion of our paper at the Atlanta Fed's 2012 Financial Markets Conference, these policies only indirectly encourage homeownership by making mortgage debt cheaper and more widely available. In the wake of the financial crisis caused by excess debt, one could question whether encouraging people to take on more debt is good public policy, especially when this encouragement is given to almost all homeowners, even those who would buy a home without government assistance. Perhaps we should consider redesigning government programs so that they are better targeted at first-time borrowers and structured in a way such that the benefits are not an increasing function of the amount of debt taken on by the borrower.

Heintjes: *Right. That's a great point. Larry, Fannie Mae and Freddie Mac are called government-sponsored enterprises, or GSEs. At its most basic, what is a GSE?*

Wall: Well, Tom, most corporations operate under charters issued by state governments. Fannie Mae and Freddie Mac are among the handful of corporations given unique charters by the federal government. They are not the only GSEs, but they are by far the largest. Under their special charters, Fannie and Freddie were, in a sense, private firms. Their shareholders were entitled to dividends from the firm's earnings; their employees were not civil servants with pay limits set by the government scale, but rather employees of a private corporation; and both of them had publicly traded stock, which allowed their senior management to receive an important part of their compensation in the form of stock and stock options.

But in a sense, they were a part of the government: they had a line of credit from the U.S. Treasury; they were exempt from the normal SEC registration required of corporations; they were exempt from federal taxes; they had access to Federal Reserve services, which are normally restricted only to commercial banks.

Of course, in return, Fannie and Freddie had some responsibility for meeting public policy objectives. In particular, the government set requirements for lending to low- and moderate-income borrowers. Further, the president [of the United States] could appoint some members of their respective boards of directors.

But the most important benefit the GSE received was a market perception that the government would bail out the creditors if one of them became insolvent. This was a huge competitive advantage because it lowered their cost of funds to levels just slightly higher than Treasury debt and well below that of highly rated (that is to say, AAA) corporations. Now, they weren't explicitly guaranteed. Indeed, the law said that they were not guaranteed. However, investors saw many signs that the government would provide a bailout if needed: the government had bailed out other GSEs; the government had allowed Fannie to operate at times in the past with almost no accounting capital and almost certainly the market value of its assets was less than its debts; and they were perceived to have become so large by the early 2000s that the failure of Fannie or Freddie would pose a threat to the financial stability of the U.S.

Heintjes: *Larry, those are all great distinctions to make. I also wanted to ask you: some housing finance observers eyed the role of Fannie and Freddie with growing apprehension. What were these concerns, and how did Fannie and Freddie respond to them?*

Wall: Well, Tom, critics were concerned about the risk that Fannie and Freddie were creating for the taxpayers. They started off with what were their fundamental risks, which were interest rate and credit risk. Now, prior to the crisis, much of the attention of critics was focused on their interest rate risk because residential mortgage lenders are exposed to substantial interest rate risk from conventional fixed-rate mortgages, both because of their long maturity and because of the prepayment option. Indeed, these losses could occur, and Fannie had sustained large losses due to interest rate risk and was likely market-value insolvent in the 1980s.

Now, there was some concern on the part of critics about credit risk, but their losses had been low precrisis, so to most critics, this seemed a relatively small concern. Moreover, these institutions had become extremely large players in the financial markets. The potential losses to the taxpayers would be very large should one fail. As noted above, Fannie and Freddie were not explicitly guaranteed, but the market believed that if one became insolvent the government would help.

In the event, these firms *did* become insolvent and *have* received government support in the form of investment of over $100 billion. Moreover, there is no realistic prospect that this investment will be repaid, unlike government investment in some of the large banks that were fully repaid.

An additional concern of critics was that the benefit of Fannie and Freddie to homebuyers is an increasing function of the amount of debt they take on. The result is that homebuyers were encouraged to take on more debt to buy bigger homes in more expensive neighborhoods than would otherwise have been the case. The result is that Fannie and Freddie subsidies contributed to the overleveraging of the U.S. consumer. Now this debt that the consumers were taking on to invest in larger homes drew in foreign lenders that increased the trade deficit and reduced the funds available to firms to invest in new jobs.

And, finally, in order to protect their government ties, Fannie and Freddie were major contributors to the political process. Indeed, some critics seemed more concerned about the impact of their political influence than about their economic impact.

Heintjes: *OK, that's a great summary of the critics' concerns. How did Fannie and Freddie respond to them?*

Wall: They started off by arguing they did not receive a benefit from the implicit government guarantee. And, indeed, Scott and I had written a paper in the early 2000s and talked with a Fannie executive here in Atlanta about it, and he was very forceful in arguing that there was no such implicit guarantee. I think our best response to him is the bailout that actually took place—it's pretty clear that they were the beneficiaries of an implicit guarantee.

They also argued that any measure which reduces their risk to taxpayers would raise the cost of home mortgage finance and reduce homeownership. Indeed, anyone arguing for such policies was labeled as a part of the coalition for higher mortgage rates. Now, clearly, some of the subsidy that they received did in fact pass through to consumers, but most estimates of the reduction in interest rates on Fannie and Freddie guaranteed loans were around 25 basis points—nice, but hardly enough to have a big impact on new home buyers.

Heintjes: *Very interesting. Larry, a collapse in housing value is inherently damaging to an economy on local, regional, even national levels. What made the recent collapse especially damaging and so prolonged?*

Wall: Residential real estate collapses are thought to have a larger adverse impact than other comparable asset price declines such as stock market declines for several reasons. Part of this is that residential real estate is typically financed with a substantial amount of debt. When real estate prices collapse that adversely impacts borrowers who not only lose part of their wealth but also cannot afford to sell if they encounter financial problems or want to move, say, to a better job. Further, many consumers in this most recent period used their houses as collateral for debt they then used to finance consumption—that is, things like purchasing SUVs and better vacations. These consumers could no longer use their home price appreciation to finance additional consumption.

Moreover, it's not just the borrowers that get hurt. The lenders to the residential real estate market also suffer losses as many of these loans default. This can be especially problematic given that many of these lenders, such as banks, rely heavily on debt financing themselves. The losses on these real estate loans can impair these lenders' ability to make new loans to finance job-creating businesses and sometimes will lead to bank failures.

Heintjes: *How would you describe the most recent housing collapse?*

Wall: Well, I would say the most recent housing collapse was especially bad for several reasons. The collapse came at the end of a major increase in residential real estate prices and a huge increase in residential mortgage debt. Loan-to-value ratios were far higher this time around than had historically typically been the case, implying that many homeowners had little or no equity in their house. As a result, as prices decreased, many

homeowners quickly went under water—that is, they owed more on their homes than it was worth. This also translates into bigger losses for lenders on those loans that do default.

Another important factor was that the collapse was national. We've had regional collapses before, such as Texas in the 1980s when oil prices dropped. However, these regional collapses did not cause a collapse in national consumer demand, nor were the losses to financial firms so large that they threatened the systemically important financial firms. This time around it was a national collapse. It decreased national demand by consumers and threatened the stability of some of the largest firms.

Finally, something that would not have been so easily foreseen, the collapse had an international impact on foreign economies that turned out to be fragile themselves. Part of this international impact came through losses to foreign financial firms from their investment in U.S. mortgage-backed securities. But another part came from reduced U.S. demand for their goods and services. But the key is that many countries were much more vulnerable to adverse shocks than we realized at the start of the crisis. Turns out Ireland and Spain had residential real estate booms that equaled or exceeded ours and have had subsequent collapses, and that the Greek government had been hiding its growing government debt. The shock from our housing collapse helped push these economies to the brink. As a result, while the U.S. appears to be bottoming out of its problems, Europe appears to be slipping into a recession and is at risk of serious financial problems if it cannot stabilize the situations in the so-called peripheral countries.

Heintjes: *Your paper talks a good bit about the notion of "tail risk," which is a term we've heard more often since the housing swoon. Can you briefly define tail risk, and why does its role occupy a central place in your discussion?*

Wall: Tom, in our paper we had a graph of the probability distribution of losses intended to illustrate our point. But rather than describe the graph, let me paint a picture in words describing the situation for the lender.

Anyone that makes or guarantees a large number of loans expects to have at least some losses. Anticipating these losses, lenders charge a sufficiently high interest rate so that they can cover the expected losses and still earn a profit. Thus, almost all of the time, the earnings on the good loans fully cover the losses on the bad loans. Now, sometimes the losses are so large that they exceed the earnings on the good loans. That's why lenders are required to have some equity capital, or owner's investment. When the losses are this large, the owners lose part of their investment.

Finally, on rare occasions, the losses exceed both the earnings on the good loans and the lender's capital. At this point, the value of the lender's portfolio is less than the lender promised to pay its creditors—in other words, the lender is insolvent. That is what we mean by "tail risk" in this paper. At that point, either the government steps in to guarantee the lender's debts or the lender goes into bankruptcy.

Thus, our concern about tail risk is just another way of describing our concern about the risk that Fannie and Freddie would become insolvent and that the taxpayers would take losses.

Heintjes: *Great. Thanks for clarifying that. What are some of the innovations or changes under discussion to alter the role of the government in the mortgage market? Do you have thoughts about which changes might prove the most effective or beneficial in the long run? And finally, do you foresee the government's role in the housing market as increasing or decreasing?*

Wall: Well, Tom, most of the proposals have come from people that are active in the mortgage finance industry or have been doing research on mortgage finance. These proposals take as their highest priority the continuing flow of funds for residential mortgages. In order to do this, they argue that the government needs to continue to absorb that tail risk—that is, provide bailouts when the losses get to be too big. These proposals typically seek to reduce tail risk by some combination of a variety of measures, such as restricting the guarantees to safer loans, prohibiting large investment portfolios that create unnecessary exposure to interest rate risk, requiring more capital from the mortgage guarantor, and requiring that the government receive fees to compensate it for the expected losses of future bailouts.

The problem in my eyes with all of these proposals is that even if they were perfectly structured to start with, almost all of the pressures will be to reduce the safeguards for the taxpayers. The gains from reduced safeguards are obtained almost immediately and the benefits are concentrated in a readily identifiable group. For example, if you relax the standards on guaranteed loans, then more people will qualify for these loans, but by relaxing the standards you are likely to have more bad loans.

Investors aren't going to charge for this because they see the government guarantee reduces their risk and so they'll be continuing to lend at a lower rate. On the other hand, the losses to the taxpayers will likely come later, maybe even decades later, and will hurt all taxpayers. So while the specific beneficiaries have an incentive to lobby for looser rules, the cost to the losers, the taxpayers, are too dispersed and too far in the future to get them to fight the change.

On the flip side are proposals that seek to have the government limit its support to things like down-payment assistance for low- and moderate-income new homebuyers—that is, to try to increase homeownership. The problem here is that it is one thing to say the government won't provide future bailouts, but another thing for the government to do nothing when the problem arises. As we discussed earlier, the U.S. residential mortgage market is a huge part of the U.S. and global financial system and the economy. The pressure on the federal government to act to save the financial system and the economy is likely to be overwhelming. Thus, even if one opposes government guarantees, there is an argument that explicit guarantees with some imperfect protections for taxpayers are better than implicit guarantees and no taxpayer protection.

Heintjes: *Larry, let me get you to look into a crystal ball here. In the future, what do you see the government's role in the mortgage market being?*

Wall: Well, Tom, with regards to the short run, Fannie and Freddie and FHA are and will remain a huge part of the mortgage market. But almost everybody agrees that this is bad and we need to return to a more private-based system, but that's going to take time to reintroduce a larger private sector.

Now, looking at the medium run, whether Fannie and Freddie will remain or be replaced is unclear. Most housing specialists advocate their replacement by a new and slightly different form of government guarantee, but getting rid of a government agency is difficult. In either case, I think the government's role in bearing tail risk from mortgages will decrease somewhat in the medium term. As to the long run, I am not so certain what will happen. That answer depends much more on politics than economics.

Heintjes: *Yeah, it's good to keep that in mind. Larry, my last question for you is this: as housing finance reform takes shape, what would you suggest interested parties focus on? In other words, what lessons should we have taken away from the events of recent history?*

Wall: Well, Tom, the lesson I wish we could most learn is that it is very costly for the government to subsidize an activity by guaranteeing loans as a way of lowering the cost of borrowing. Government guarantees are very seductive in the short run. It looks like something for nothing. The government provides a subsidy to borrowers, which encourages the borrowers to do something deemed socially desirable. The borrowers obtain an immediate gain. So often do the people selling the goods, such as in the housing industry—the homebuilders and the realtors. Yet this subsidy can be structured in a way where it shows no cost to taxpayers for long periods of time.

But eventually the socially desirable activity becomes oversupplied, and the borrowers take on too much debt. Then the seemingly costless government guarantee becomes extremely costly for taxpayers as the government makes good on its loan guarantees. Moreover, it often turns out badly for many of the borrowers as they struggle to support excessive debt and/or they default on their debt, ruining their credit ratings and, increasingly, their access to other things such as jobs. Thus, I would argue that any activity that we agree should receive government support should receive that support with an upfront grant of government money rather than through debt guarantees. Moreover, I would hope the support would be structured in a way that does not encourage people to take out larger loans.

Heintjes: *That's a great point. Larry, this has been an extremely illuminating discussion, and I really thank you for joining us today.*

Wall: Thank you very much for the opportunity.

Heintjes: *This concludes our podcast with Larry Wall, Atlanta Fed economist, on his recent research on the government's role in the housing finance market. On our website, frbatlanta.org, you can read Larry's paper, "The Devil's in the Tail: Residential Mortgage Finance and the U.S. Treasury."*

If you have comments or questions, please e-mail podcast@frbatlanta.org. Thanks for listening.