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Ten Arguments Against a Government Guarantee for Housing Finance

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There are many possible ways to reform the U.S. housing finance system, but any explicit government guarantee for housing, whether by the sale of insurance on mortgage-backed securities or a new public utility model, would be a tragic mistake. It would repeat the errors of history by putting taxpayers and the housing industry itself at risk. Here are ten reasons why:

1. Government guarantees always underprice risk. All federal guarantees underprice risk in order to provide a subsidy for lending. That is their purpose. And taxpayers will be exposed to losses in the future, as those risks materialize.

2. Guarantees eventually create instability. Guarantees failed to prevent the savings-and-loan crisis and subprime crisis. In fact, they contributed to the cause of both by distorting the market.

3. Guarantees inflate housing prices by distorting the allocation of capital investments. The artificially increased capital flow will make mortgages cheaper, boosting demand for housing and pushing up prices, ultimately creating another bubble.

4. Guarantees degrade underwriting standards over time. Historically, a primary justification for guarantees has been to increase the availability of finance to politically important groups with higher credit risks. It is inevitable that this will continue to happen, requiring the government to lower underwriting standards, and resulting in more risky mortgages.

5. Guarantees are not necessary to ensure capitalization of the housing market. As has begun already, the jumbo market will evolve and practically any credit-worthy potential homebuyer will be able to get a mortgage in a fully private system.

6. Guarantees are not necessary for homeownership growth. Other nations have substantially higher homeownership rates in spite of having far less government interference in their housing markets.

7. Guarantees drive mortgage investment in unsafe markets. As long as there is a government guarantee covering financial institutions, investors and lenders will look to the government's credit, not the credit of institutions and loan applicants themselves.

8. Guarantees are not necessary to preserve the "To Be Announced" market for selling mortgage-backed securities. If needed, a TBA market could easily develop with originators hedging against any short-term interest-rate risks in the private sector.

9. Guarantees are not needed to prevent "vicious circles" that drive down prices. Mild price movements in the housing market are necessary to keep balance in the market. Keeping prices artificially high reduces housing demand and prolongs recovery. The most common threat of default as prices decline is from borrowers who have little equity in their homes—because they borrowed at high loan-to-value ratios—seeing the value of their homes drop below what they owe. Guarantees support these high-credit-risk borrowers.

10. Even a limited guarantee on just mortgage-backed securities targeted at protecting against the tail risk will slowly distort credit allocation and investment standards, ultimately destabilizing the market and forcing the need to rely on the guarantee.

For more information, go to www.reason.org or contact: anthony.randazzo@reason.org