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# Ten Arguments Against a Government Guarantee for Housing Finance

by Anthony Randazzo

## INTRODUCTION

There is a growing belief among mortgage investors, industry groups and some policymakers in Washington that some type of explicit government guarantees for mortgage lending will be necessary to undergird a new housing finance system in America. Yet whether by the sale of insurance on mortgage-backed securities or a public utility model replacing Fannie Mae and Freddie Mac with new government-sponsored enterprises, this would be a tragic mistake, repeating the errors of history, and putting taxpayers and the housing industry itself at risk.

This policy summary offers ten arguments for why there should be no government role—explicit or implicit—in guaranteeing housing finance.

### 1. Government guarantees always underprice risk.

The nature of any government guarantee is ultimately to underprice risk in order to provide a subsidy for lending that wouldn't be available in a solely private market. Regulators may be highly cautious now in pricing a guarantee, but that does not ensure standards won't break down in the future, particularly when credit losses are low and

This is a four-page summary of a more detailed policy brief that is available at

http://reason.org/studies/show/housing-finance-reform

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housing price appreciation is high. While some may argue this is unlikely to happen, that same argument was pervasive over the past decades, and we have seen how that story ended.

## 2. Guarantees eventually create instability.

Not only did guarantees fail to prevent the savings-and-loan and subprime crises, but they were among the underlying causes of both. Federal support for the S&L industry and then for mortgage investors via Fannie Mae and Freddie Mac led to the substantially reduced market discipline seen in both cases. The guarantees distorted the housing market, fueled unsustainably high prices that inevitably collapsed, and encouraged extraordinary risk-taking at the GSEs and private sector firms. This destabilized the market and led to hundreds of billions in losses for the taxpayer. A another guarantee would do the same since their goal is always to distort the market.

## 3. Guarantees inflate housing prices by distorting the allocation of capital investments.

The aim of any government guarantee, whether implicit or explicit, is to encourage more mortgage lending than would otherwise take place without the subsidy for risk. This inherently means that resources would be rerouted into housing finance away from where the market would otherwise determine to be their best use. The additional capital makes mortgages cheaper and more readily available, boosting demand for housing and pushing up home prices. Ultimately this unsustainable, artificially boosted flow of capital creates a bubble similar to the phenomenon seen in the last decade. The growth of that bubble hurts buyers looking for affordable homes as prices rise, and hurts sellers once the inflated home values collapse.

## 4. Guarantees degrade underwriting standards over time.

Even the chastening of the financial crisis is unlikely to change the nature of politicians who will always want government subsidies to accomplish their public policy objectives or reward select constituencies. This is what led HUD to encourage the spread of subprime loans backed by government-supported institutions during the last bubble. And while some may argue that "this time is different," that mantra has been used many times before. Historical analysis suggests a government guarantee likely means the high underwriting standards today will eventually be weakened to advance some type of "affordable housing" goals in the future. But these goals are inherently destabilizing and would just lead to another bubble. This will ultimately wind up hurting those that the policymakers are trying to help, such as the low-income families struggling today as a result of previous affordable housing policy failures.

## 5. Guarantees are not necessary to ensure capitalization of the housing market.

Defenders of government guarantees argue that without a subsidy, there will not be enough mortgage lending for the current $11 trillion residential housing market. However, a smaller housing market is not inherently problematic, since the notion of an $11 trillion market is completely arbitrary. Without the subsidy, it is likely there would not have been as much lending for housing over the past few decades anyway, since there would have been no public policy pushing mortgages for homebuyers that are not financially stable enough to own a home. The jumbo market—comprising loans above the size limits of mortgages that can be purchased by Fannie or Freddie—is returning to life and will be able to capitalize enough of a market so that if a potential homebuyer is a creditworthy borrower and healthy investment for the lender, he will almost certainly be able to get a mortgage in a fully private market. As mortgage lending transitions from a subsidized market to one without government guarantees, investors who only want to loan with taxpayers covering their losses will exit the market. Credit will be shifted mainly to creditworthy, stable borrowers, and will cease being readily available for homebuyers who aren't financially ready to own a home.

## 6. Guarantees are not necessary for homeownership growth.

Many argue guarantees are necessary to maintain growth in the homeownership rate by preserving the 30-year fixed-rate mortgage. It is far from clear that

increasing the homeownership rate is a sound policy goal. But even if it were, guarantees are a flawed means to accomplish that objective. A review of the rates on 30-year fixed-rate mortgages over the past 40 years shows no consistent relationship between government guarantees and homeownership rates (see full version of this policy summary for the data). Furthermore, even with the guarantee subsidy, the United States is still ranked only 17th in homeownership among the top 25 developed countries—including Singapore, Belgium, and Chile—many of which have been able to achieve higher rates of homeownership without American levels of government intervention. Ultimately, using a taxpayer subsidy to allow people to become homeowners before they are financially able does not promote sustainable homeownership, as the current housing mess illustrates.

## 7. Guarantees drive mortgage investment in unsafe markets.

The implicit government support of Fannie Mae and Freddie Mac meant investors in the GSEs and those paying for guarantees on their mortgage-backed securities did not have the incentives to perform proper due diligence. As long as there is a federal guarantee covering financial institutions, investors and lenders will look to the government's credit, not the credit of private institutions or loan applicants themselves. Furthermore, the financial support of guarantees would help keep failing institutions operational long after they would have been declared insolvent with creditors stopping their investments had they been non guaranteed. This is exactly what was allowed to happen with Fannie and Freddie during the housing bubble, leading to significant taxpayer losses.

## 8. Guarantees are not necessary to preserve the TBA market.

Many believe that a "To Be Announced" (TBA) market for mortgage-backed securities is an important part of housing finance because it allows originators and investors to use government guarantees to hedge against risk while mortgages are finalized, separated into pools, and fully securitized. Fannie Mae and Freddie Mac facilitate this market now, but a new market could easily develop for non-government guaranteed mortgages. Currently, Fannie and Freddie issue securities to be traded that list loan characteristics but don't "announce" the exact mortgages in the pool until 48 hours prior to established trade dates. However, government guarantees are not necessary to preserve this TBA market. Private mortgage lenders can announce their intention to sell a security, and then, over a short period of time between when mortgages intended to be added to the security are closed and sold, they can hedge against the interest-rate risk present in the fixed-rate mortgages on their balance sheets or in warehouse lines. This allows the TBA market to develop, but only with lenders paying closer attention to how to manage their risks.

## 9. Guarantees are not needed to prevent "vicious circles" that drive down prices.

Price movements in the housing market are necessary to keep market balance. Price declines help to sell off building inventories of homes, and price increases signal the need for more resources so that supply can meet demand from homebuyers. But there are some who argue that guarantees are necessary to ensure mortgage investors will refrain from becoming risk-averse in a bumpy market and to drive down prices in a loop on fears of further price declines. This is a groundless fear since lenders are aware of the natural cycles in housing. And it is dangerous to support keeping prices artificially high with a guarantee since this reduces housing demand and prolongs recovery. Furthermore, a "vicious circle" of price declines leading to defaults leading to risk averse behavior would be unlikely in a fully private market governed by sound underwriting standards that required 10 to 20 percent downpayments.

## 10. Even a limited guarantee targeted at protecting against the tail risk will slowly distort credit and investment.

Several proposals for replacing Fannie Mae and Freddie Mac have suggested a government guarantee on mortgage-backed securities themselves, trying to avoid the moral hazard associated with directly supporting financial institutions. The idea is basically

to provide a guarantee to protect against the tail risk of mortgage defaults—that is, to protect against an extreme scenario such as the recent subprime meltdown. However, such a system would still assume the government can properly price the guarantee, and it does not address the inherent distortions with over-incentivizing capital in one sector of the market. A limited guarantee would just build a bubble slower, one that would still eventually need to unwind. In this way, even protecting against the tail risk is a self-fulfilling recipe for a taxpayer bailout.

## CONCLUSION

Many interest groups argue that federal intervention and guarantees are necessary for the future of housing finance and that this time is different. However, prior interventions and guarantees have a checkered past of adverse unintended consequences which leave no doubt that their proposals will once again privatize gains and leave the taxpayers with the losses. Policymakers should beware of arguments characterizing a guarantee as vital or inevitable. Supporters of a guarantee should review their own research to look at the failures caused in the past by similar subsidies. The evidence is strong that guarantees do not preserve the housing market, but rather destabilize it, and are not even necessary to promote affordable housing. A huge amount of private capital is available to finance recovery and growth. There is no need for taxpayers to subsidize the future mortgage finance system and many reasons not to. The market can, and should, be left to fund American housing itself.

## SUMMARY

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3. Guarantees inflate housing prices by distorting the allocation of capital investments.
4. Guarantees degrade underwriting standards over time.
5. Guarantees are not necessary to ensure capitalization of the housing market.
6. Guarantees are not necessary for homeownership growth.
7. Guarantees drive mortgage investment in unsafe markets.
8. Guarantees are not necessary to preserve the TBA market.
9. Guarantees are not needed to prevent "vicious circles" that drive down prices.
10. Even a limited guarantee targeted at protecting against the tail risk will slowly distort credit and investment.

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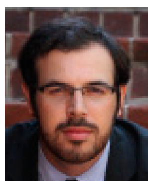

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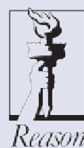


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