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Statement of the Shadow Financial Regulatory Committee

Comment on the Treasury’s White Paper: Reforming the Housing Finance Market

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Last week, the Administration released its eagerly awaited report on reforming the housing finance market. The Dodd-Frank Act had omitted consideration of the government sponsored enterprises (Fannie Mae and Freddie Mac) because they were perceived to be sufficiently important to warrant separate consideration. Along with the Federal Housing Authority, they were guaranteeing 95 percent of the mortgage lending in the US. The Treasury was mandated by Congress to present an array of options for the future of the housing finance system. The problem requires urgent attention because it is clear that the government cannot sustain the burden of guaranteeing most mortgage lending. Indeed, with the GSEs in conservancy, it is estimated that taxpayers are already on the hook for up to $400 billion.

The report reviews the current housing finance system that would reduce “the Government’s primary role … to robust oversight and consumer protection, targeted assistance for low- and moderate-income homeowners and renters, and carefully designed support for market stability and crisis response.” The report concludes that past “the Government’s financial and tax policies encouraged housing purchases and real estate investments over other sectors of our economy and left taxpayers responsible for most of the risk incurred by a poorly supervised housing finance market.”
The report includes three options for reforming the system. These options include: (1) a wholly private mortgage finance system; (2) a private system with a standby facility for market breakdown; and (3) what is essentially a replacement for Fannie and Freddie with an on-budget backup guarantee for all middle-class mortgages. All of these options assume that Fannie and Freddie will be wound down. Their conclusion of option one—a wholly private system—is a surprise and responds to critics—including the Shadow Financial Regulatory Committee—who have argued for years that government support for mortgages could only end badly (see, for example, Shadow Financial Regulatory Committee Statement No. 131, February 1996, or Statement No. 281, May 2003).

Of the three options for reform in the Treasury White Paper, the Committee comes closest to favoring the first, which offers a completely private sector system for housing finance while shifting responsibility for subsidizing low-income households to the FHA and VA. The Committee would prefer the subsidies take the form of targeted cash grants that flow through the government. In this way, subsidies are more transparent and can be allocated more efficiently. Thus, housing subsidies will compete with other worthy programs in the budgetary process.

Because the government currently supports nearly all of new housing lending the phase-out of the GSEs will need to be carefully staged. But the plan should leave no doubt that GSEs will disappear. This will enable the private sector to make plans for expanding mortgage lending as the GSEs recede in importance. The Committee believes that the phase out should start within one year with no further mortgages purchases for their portfolios and the current portfolios put in liquidation mode. The guarantees of securitizations could be reduced in measured fashion by reducing the ceiling on eligible mortgages by 20 percent a year for five years.

Evidence from several empirical studies suggests that the elimination of the GSEs would put only a minor upward pressure on the mortgage rates, primarily reflecting the termination of the implicit subsidy. This may temporarily reduce the supply of mortgage finance and speed the decline of housing prices to their equilibrium level. Inevitably, house prices will have to fall to the cost of land and replacement construction. This will be a painful process for those who have no equity in their houses, but prolonging their agony will only delay recovery by maintaining an excess supply of houses overhanging the market. Moreover, the sooner new home buyers enter the market (after they believe it has reached equilibrium) the sooner neighborhoods can be revived by households that did not succumb to the temptation to over-leverage themselves. The sooner the housing market revives, the sooner job mobility will be restored and a significant drag on economic recovery will be removed.