Mortgage Finance: Which Way Forward (or Backwards)

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Does Homeownership Merit Subsidy?

• Homeownership correlates with lots of positive outcomes.
• Homeownership not without its costs.
• Marginal and average homeowner not the same.
• Externalities generally local in nature.
• Job, economic-impact exaggerated.
  – We all have to live somewhere.
Homeownership Gains Largely Precede GSE activity
Added Leverage has not delivered long-term gains

Is Debt Ownership?

Ownership rate
Debt to Value

We can fund our own mortgage market
GSEs, Liquidity and Branch Banking

• 1930s liquidity solution to fragmented banking system.
  – 1935: 14,125 banks; 3,112 branches
  – 2011: 6,291 banks; 83,209 branches

• Geographic diversification problem solved?

• Lender of Last Resort
  – Federal Reserve
  – Federal Home Loan Banks
If not GSEs, then who funds the mortgage market?

- Not a $10 trillion Q, so much as a $7 trillion.
- No need for a big bang.
  - 2012 needs about $1 trillion in originations.
- Those who fund GSE can fund the mortgage instead.
  - Banks – have capital/deposits for 2012 need.
  - Pension/insurance – possible $1 trillion.
  - Mutual Funds – another $trillion.
Concentration of GSE risk in banking sector: Systemic risk, anyone?

| Holdings of GSE-Related Securities By FDIC-Insured Institutions as of 12/31/10 |
|-------------------------------------------------|-----------------|-----------------|-----------------|
| Securities ($ 000)                              | Holdings to Tier 1 Capital (%) | Holdings to Total Assets (%) |
| Direct Obligations                              | 276,751,917      | 23.8            | 2.1             |
| Savings Associations                            | 33,907,579       | 34.7            | 3.6             |
| Commercial Banks                                | 242,844,338      | 22.8            | 2.0             |
| MBS                                              | 1,097,918,179    | 94.5            | 8.2             |
| Savings Associations                            | 139,774,254      | 142.9           | 15.0            |
| Commercial Banks                                | 958,143,925      | 90.1            | 7.7             |
| Total                                            | 1,374,670,096    | 118.3           | 10.3            |
Backwards to go forward
A deposit-based mortgage finance system

- Most of developed world is deposit-based.
- Reduce asymmetric information problems.
- Much of securitization was Basel driven.
- Improves loss mitigation, reduce foreclosures.
- Limited geographic diversity problem solved.
- Deposits “sticky”
Sectors w/o extensive guarantees performed no worse.
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If we fund auto loans w/o guarantees….

- Affordable rates, currently around 4.7%.
- Fixed rate generally available for up to 5 years (average mortgage life = 7 years).
- While some problems, auto loan market continued even as auto-ABS channel declined.
- High Loan-To-Values.
- Easier to collect (bring back recourse).
Towards A Positive Political Economy of Mortgage Finance

• Insurance Premiums will be under-priced.
• System will likely be pro-cyclical.
  – Democracy loves a bubble.
• Standards/Safeguards will be eroded.
• Federal insurance is cash-flow driven.
• Funding pressure make contingent liabilities more attractive.
Crisis was not “tail event”

• Competition and Guarantees don’t mix.
  – Competitive pressures insure guarantees will be called upon.

• Housing/Business Cycle not going away.

• Gov’t Regulation insufficient to control moral hazard.
  – Weak regulatory incentives.
  – Political pressures.
Safe As Houses?

5 year change in real house prices
Source: Robert Shiller
Policy Principles

• No capital arbitrage – like capital for all.
• No credit allocation.
  – No special status for housing.
• Risk-bearing must be transparent.
  – No contingent liabilities.
• Finance should not be a tool for redistribution of wealth/income.
  – Transfer should be on-budget, appropriated.
Conclusions

• Already have buyer of last resort – Fed.
• Backstop as likely to create a crisis as to help resolve or avoid one.
• Mortgage Finance System only as good as your monetary policy.
• Political system as source of systemic risk.
• There are sufficient “private” funds to support the mortgage market.