Mortgage Financing Beyond the GSEs

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The Setting

With the collapse of private securitization, virtually all residential mortgage securitization is now in the hands of the U.S. Government.

The housing GSEs, once the envy of the world, remain in government conservatorship and in political limbo, having cost the taxpayer almost $200B to date.

Question of the day: should the U.S. remain in the mortgage insurance business, and if so, on what terms?
Indictment of the GSEs

- Only about half the 30-40 basis point GSE funding advantage was passed to consumers in lower rates
- GSE affordable housing loan purchase programs were of limited efficacy in achievement of homeownership
- The GSEs had a destabilizing influence on mortgage markets and served to exacerbate the subprime boom
- The GSEs contributed little to MBS innovation
- During the boom years, the GSEs crowded out private mortgage purchase activity
But as boom turned to bust....

- Private mortgage origination and securitization fell away
- GSE crowd out disappeared
- Federally-backed loans achieved a 95% market share
- GSE securitization with explicit U.S. guarantee remained robust at about $300B per quarter
- GSEs in government conservatorship became an important instrument of macroeconomic and housing stabilization policy
MBS Share Issuance (Percent of MBS Issuance)

Note: Private-Label MBS excludes scratch & dent loans and re-MBS (1995-2011)
Housing Market Integration and the Collapse of Residential Securitization

• As the housing downturn deepened, geographic diversification of MBS holdings by investors and insurers yielded few benefits.
• Even seemingly well-diversified MBS investors experienced substantial losses, owing in part to high levels of systemic risk in US housing markets.
• Private security issuers, investors, and insurers did not understand the high levels of geographic and temporal integration, correlation, and contagion pervasive in US metro housing markets.
Housing Return Integration Trends
Average R-squares for US MSAs and California MSAs
Incidence of Extreme Movements in US House Price Returns
Percent Lee and Mykland House Price Return Jumps for US MSAs by Quarter
## Metropolitan House Price Contagion

Los Angeles

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Constant</th>
<th>Lag0</th>
<th>Lag1</th>
<th>Lag2</th>
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Government-Backed Credit Guarantor

- In a severe downturn, a private insurer of mortgage risks may not be viable, given geographically and temporally correlated credit losses, the substantial magnitude of required guarantees, and constrained access to capital markets.
- Here an explicit government guarantee may be necessary to resolve problems of systemic risk, facilitate issuance and hedging of long-term debt, enhance financial stability, and provide the FRB with more options to deal with a liquidity crisis.
- If the guarantee is credible, MBS can be traded among investors in all market conditions—whether times are good or bad.
Government-Backed Credit Guarantor

The Guaranteed Product
- super safe, homogenous, plain vanilla mortgage
- government’s role would be narrowed to deeply subordinated loss position and would come into play only in severe housing downturn
- low required LTVs on government-backed mortgages imply that borrowers, lenders, PMI, and the like take first loss position

Actuarially Fair Pricing of Explicit Credit Guarantee
- Risk-based pricing of insurance premia would be based on loss expectations associated with severe downturn

Portfolio Holdings
- Treasury White Paper calls for sharp cut-backs in portfolio holdings
- Absent affordable housing goals, little need for portfolio holdings of private non-prime MBS
Moving forward....

Goals of Federal Government in Support of Housing
- facilitate liquidity, financial stability, and funding of mortgages at reasonable costs in good and bad times
- assure adequacy of homeownership and rental options (re-balance tenure bias)

Underserved Populations/Affordable Housing Goals
- eliminate harmful conflation of social and private missions of mortgage insurer
- transfer residual homeownership goals to FHA, VA

Timeframe of Transition from GSE Model
- liquidity provision by the GSEs remains vital to current fragile housing market
For a detailed analysis of integration, correlation and contagion in US housing markets, see: