

Why fix the mortgage market?

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Starting in the summer of 2007, spreads in the mortgage markets, along with most of the broader credit markets began to rise sharply, leading to a significant decline in prices. By mid-2008, issuances of consumer credit securitizations fell from an annualized rate of \$1.5 trillion per year to a trickle, causing a collapse of credit in every consumer market funded by securitization. Private student loans completely disappeared. Auto loans became prohibitively expensive and nearly impossible to get. Banks pulled back on credit cards.

These problems were most pronounced in the mortgage market, in which government-sponsored entities Fannie Mae and Freddie Mac rely on bond issuance to fund mortgages. As their troubles mounted, the GSE's borrowing costs rose rapidly along with the rest of the industry. Mortgage spreads grew nearly one percentage point above historical levels. With the collapse of the private mortgage market, the GSEs and FHA moved to originating about nine in ten mortgages. The government placed the GSEs in a conservatorship with the goal of fixing the mortgage market. At that time, for all intents and purposes, the mortgage market was in government control.

Yet the government's conservatorship of Fannie Mae and Freddie Mac had little effect on mortgage rates. As inventions to explicitly guarantee other types of bank borrowings and expand deposit insurance took hold, bond buyers and investors ran toward any debt with no risk and explicit government guarantees. Within weeks of the government's conservatorship, mortgage spreads *rose* to even higher levels than before. The credit crunch tightened its grip on the economy.

Watching these events, in September of last year, we wrote an opinion piece on these pages proposing that the government live up to its promise to fix the mortgage market when it took over conservatorship of the GSEs. We proposed bringing mortgage spreads back to their historical level of 160 basis points over the 10-year U.S. Treasury yield, with the promise that such a move would help stabilize the housing market and reduce consumer borrowing costs, as well as injecting a much-needed stimulus into the economy of nearly \$200 billion per year in lower mortgage payments. In December, we wrote a follow-up piece on these pages supporting the leaked Treasury plan to lower rates for new home buyers and argued it should be expanded to include refinancings. Such a plan would improve bank liquidity. Up to \$2 million of second liens, jumbo mortgages, and non-conforming loans would pay off early. This also helps separate good mortgages from bad mortgages, a key part of any bank recovery plan. In neither of these pieces did we argue for a fixed mortgage rate, but a rate defined as a spread over 10-year U.S. Treasury rates.

In recent opinion pieces, Professor Edward Glaeser from Harvard and the *Wall Street Journal* editorial board criticized our proposal on several grounds, including the fact that it would amount to nationalizing the housing finance system ("A Republican Fannie Mae"), it would cost taxpayers \$135 billion, and that we misunderstood housing trends. Our plea on all three accounts: not guilty.

First consider the "nationalization" claim. Like it or not (we do not), that has already happened. The government now originates more than 90 percent of home mortgages. The few remaining jumbo mortgages have rates over 7 percent, even with record low Treasury interest rates. The only reason that mortgage spreads have declined recently is that the Federal Reserve has

committed to purchase up to \$500 billion of GSE securities, potentially leading to higher inflation in the future and exposing taxpayers to great credit risk if long-term interest rates rise in the future.

Now to the next critical question: Why should we subsidize mortgage rates? The answer is, of course, we should not – and our proposal does no such thing.

Consider the 30 million mortgages currently outstanding on which the government now already owns credit risk. For these mortgages, the government is simply passing along lower borrowing costs to consumers. Without a credit crunch, this would happen absent government intervention. In refinancing the 30 million existing mortgages originated through the GSEs, the government would earn a spread of 160 basis points above the 10-year U.S. Treasury rate. Lower mortgage payments could also reduce millions of new defaults and foreclosures, saving taxpayers additional amounts. Far from a subsidy, this is almost surely a profitable transaction for taxpayers who are already saddled with more than \$5 trillion of mortgage guarantees issued in previous years.

For the estimated additional \$2 trillion of additional refinancings and new mortgages, the government should charge an appropriate spread to ensure no taxpayer losses. Again, it is important to note that the government is already issuing mortgages at higher rates; we believe that the right spread is much lower than is now being charged. The conventional spread of 160 basis points covers credit risk, prepayment risk, and underwriting costs. At the low interest rates our plan would produce prepayment risk would be modest. We are aware of no evidence – and our critics have produced no such evidence – that credit risk would exceed 160 basis points to cause a taxpayer loss. To the extent that concerns arise about capital losses to the government in the event of a future rise in nominal interest rates, the Treasury could use long-term funding to support the mortgage lending.

Finally, critics argue that we misunderstand house price trends. Our model of evaluating the impact of interest rates on house prices compares the cost of owning a house relative to renting, the same model used for most Wall Street analysts and most theoretical analyses of asset prices in finance. As a matter of economic theory (and empirical evidence), it is inconceivable to argue that interest rates have little impact on house prices and housing demand. Ask any American about their decision to purchase a house or refinance a mortgage, and he or she will tell you the same thing.

Independent economic forecasters and financial futures markets suggest that, without action, house prices will continue falling into 2010 by an additional 20-25 percent. With unemployment rising and the economy contracting, lower rates will at most help stabilize house prices, not re-inflate the housing bubble. But this stabilization will limit further damage to banks' balance sheets that could increase the likelihood of nationalization.

Senators McConnell and Ensign, as well as the many Republican supporters in the Senate, deserve our praise for standing up to support this important policy intervention that will help our country. Under the newest version of this plan, more than 40 million borrowers would save over \$423 per month by refinancing. In Senator McConnell's home state of Kentucky, 500,000 borrowers would save \$250 per month. In Senator Ensign's state of Nevada, 477,000 borrowers would save \$443 per month. In the hard-hit states of California and Florida, about 4.5 million and 3.2 million homeowners would save \$700 and \$393 per month, respectively. These figures translate to a total fiscal stimulus that totals \$200 billion per year that borrowers would benefit from within months. It is the equivalent of a significant permanent tax cut for middle-income Americans, with a much greater effect on consumer spending of a one-time rebate. Democrats such as Representatives Cardoza and Dingell should receive equal praise for considering such a plan in the House.

The housing market remains at the heart of many woes in our financial system. We cannot right the ship of the economy and the financial system with housing markets in disarray. Our proposed time-limited plan can restore normal mortgage markets, giving both an economic boost and time to figure out how to prevent a future such crisis. And we can do so with only a small cost to taxpayers. The alternatives? From the Obama administration, a stimulus package that more closely resembles the spending excesses of the past decade than FDR. From this editorial page, a Mellon-like liquidationist view that will put further downward pressure on consumers' and financial institutions' net worth, increasing the likely scope for government intervention.

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