

We still need to fix the mortgage market!

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This week President Obama announced his plan to help the housing market. Despite heightened expectations and initially positive reports, the stock market has resumed its downward spiral. The housing package was incredibly generous to homeowners who are having trouble making mortgage payments, but it offers little help to the large majority of Americans who are making their payments on time and may be living in a house worth less than their mortgage amount. And the plan does nothing to provide reasonably priced credit to the new home buyers that are needed to absorb the inventory of vacant houses that are leading to deteriorating neighborhoods and falling house prices.

Part of the stock market's response to the disappointing policy announcements has been the Administration's unwillingness to seriously take on the overall housing market, which is the 800 pound gorilla in the room. The Administration stated, "The present crisis is real, but temporary. As home prices fall, demand for housing will increase, and conditions will ultimately find a new balance." Such an attitude appears cavalier, given that housing credit is excessively tight and expensive based on historical norms. The current credit markets are not an example of free markets working, but of the worst national credit crunch since the Great Depression.

While politicians stand by, house prices continue to spiral downward. House prices have already overshot their equilibrium values. Every month, more than a hundred billion of consumer wealth is wiped out and the balance sheets of banks and financial institutions collapse as their mortgage portfolios fall further in value. While everyone talks about the TARP money into the banks and AIG, they ignore the additional \$200 billion we just had to put into Fannie and Freddie to keep them afloat. Almost surely the GSEs and the banking system will require even larger taxpayer payouts in the future. The best way to stabilize the banking and financial system is to stop further losses from happening. Without dealing with the underlying housing problem, it is hard to imagine moving forward.

To understand how to fix this problem, it is useful to go back to how we got here. High leverage associated with securitization and over-extended financial institutions caused subprime mortgage losses to reverberate throughout the credit markets. Starting in the summer of 2007, nearly \$1.5 trillion per year of consumer credit funded by securitization disappeared. By the fall of 2008, the failure of credit markets caused a complete collapse in any credit-dependent consumer markets. Car purchases fell 50% or more as auto loans became nearly impossible to get. Foreign students had to drop out of American colleges as they could not get loans. Consumer and business credit card lines were sharply cut back. In all of these cases, an economic slowdown was exacerbated by lack of credit.

The mortgage market, which relied heavily on securitization, was hit as hard as other credit markets. Privately issued mortgage-backed securities disappeared entirely. Even government-sponsored entities like Fannie Mae and Freddie Mac have had trouble raising money. Spreads on the bonds that the GSEs issue to fund mortgages rose nearly one percentage point above historical levels. Unlike private asset-backed securities, the rising spreads did not reflect credit risk. GSE bonds are guaranteed for losses from underlying mortgages. The only risk on these bonds is that they will be prepaid early due to falling interest rates. Yet even as interest rates fell and prepayment risk declined,

the spreads on GSE bonds rose. Although spreads on government loans were high, these mortgages were cheaper than private mortgages, which were unavailable to all but the very best borrowers. Even for GSE loans, credit standards have tightened to excessive levels. The average loan-to-value ratio for a new loan issued by Fannie Mae was 27% in the third quarter of 2008.

In September, 2008, the government placed the GSEs in a conservatorship with the goal of fixing the mortgage market. 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.

Watching these events, in September of last year, we began to call for 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. We have never argued for a fixed mortgage rate, but a rate defined as a spread over 10-year U.S. Treasury rates.

In recent opinion pieces, this proposal has been criticized on several grounds, including the fact that it would amount to nationalizing the housing finance system, it would cost taxpayers hundreds of billions of dollars, 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. Yet, the Federal Reserve will need to purchase these bonds in even larger amounts in coming months. We should not pretend that Fed purchases are somehow costless and risk-free, even if government accounting does not show an explicit cost of these purchases to taxpayers. How will the fed unwind its balance sheet? What about future risk of inflation? What is the risk if long-term interest rates rise? The fed purchases these bonds with cash, exposing taxpayers to appreciable interest rate risk. Our plan does not have these risks.

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.

The current Obama proposal is a small step in this direction, but is still much too limited and expensive for consumers. It requires consumers to apply for a refinancing, an expensive and slow process that requires consumers to pay lenders thousands of dollars in fees and points, get a new appraisal, and file new paperwork. This is a boon to the mortgage industry, but also unnecessary. The government already has the credit risk for all of these loans. As well, by limiting the process to borrowers who live in houses with a loan-to-value ratio below 105%, they exclude borrowers in the hardest hit parts of the country like California, Nevada, and Florida, where credit is needed the most but millions of borrowers are too far underwater to benefit from the program. Overall the Administration estimates that up to 5 million borrowers will qualify. The restrictions unnecessarily leave 25 million remaining GSE borrowers out in the cold and charge the 5 million too much money.

The new housing proposal does absolutely nothing for the estimated 20 million non-GSE borrowers who are current on their mortgage. The government could help these homeowners by lowering mortgage rates and ensuring that credit terms are not excessively tight. 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. The Treasury should use long-term funding to support the mortgage lending, hedging taxpayer risks if interest rates go up in the future.

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 other 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 \$400 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. So what is the downside?

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