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To Guarantee or Not to Guarantee — That is the Question*

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In Shakespeare's play Hamlet, Hamlet famously poses the question, "To be or not to be . . . " For the Prince, the answer to that question was a matter of life or death. This article addresses a less profound, but nonetheless timely variation on Hamlet's question: to guarantee or not to guarantee? This question will be at the heart of the forthcoming debate over GSE reform. It relates to whether or not the Federal Government should "explicitly" guarantee mortgage backed securities (MBS) created by any successors to Fannie Mae and Freddie Mac (collectively the GSEs).

The need for and implications of an explicit federal guarantee on MBS for conventional mortgages were explored in three Congressional hearings held just before the election recess.[1] This article examines the arguments raised during those hearings on both sides of the question.[2]

The Growing Call for Some Form of Explicit Federal Insurance

Several of the leading trade associations for the housing finance industry have called for the establishment of an "explicit" federal guarantee on MBS created by the successors to Fannie Mae and Freddie Mac. Importantly, the proposed federal guarantee would apply only to the MBS, not

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[1]See "The Future of Housing Finance: A Progress Update on the GSEs," a hearing held by the Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises of the House Financial Services Committee, September 15, 2010; "The Future of Housing Finance: A Review of Proposals to Address Market Structure and Transition," a hearing held by the House Financial Services Committee, September 29, 2010; and "A Comparison of International Housing Finance Systems," a hearing held by the Subcommittee on Security and International Trade and Finance of the Senate Banking Committee, September 29, 2010.

[2]Our firm has been retained by the Housing Policy Council to support its work on GSE reform, and the Housing Policy Council has endorsed an explicit federal guarantee on MBS.

the entities that issue the MBS. The purpose of the guarantee, as discussed further below, is to enhance liquidity, not protect shareholders. The trade associations that have endorsed a federal guarantee on the MBS include the Securities Industry and Financial Markets Association (SIFMA), the Mortgage Bankers Association, and the Housing Policy Council of The Financial Services Roundtable. The Center for American Progress, a "progressive" think tank, and some academics, such as Philip Swagel of Georgetown University, also have endorsed the concept.

On the other hand, during recent Congressional hearings on GSE reform, some witnesses raised serious concerns with an explicit federal guarantee, and several members of Congress expressed their own reservations with the concept. One witness, Edward Pinto, a former executive vice president for Fannie Mae and Freddie Mac, told the House Financial Services Committee that "a housing finance system built upon government guarantees poses an inherent risk to homeowners and taxpayers alike." (Testimony before the House Financial Services Committee, September 29, 2010)

Likewise, the Acting Director of the federal agency that supervises Fannie Mae and Freddie Mac, Edward DeMarco, acknowledged the growing call for some form of an explicit guarantee but urged caution:

> Recently there has been a growing call for some form of explicit federal insurance to be part of the housing finance system of the future. While such an outcome has certain merit and some attractive features, I believe that the potential costs and risks associated with such a framework have not yet been fully explored. To put it simply, replacing the Enterprises' "implicit" guarantee with an explicit one does not resolve all the shortcomings and inherent conflicts in that model, and it may produce its own problems. (Testimony of Edward De Marco, FHFA, before the House Financial Services Committee, September 15, 2010)

The debate over an explicit federal guarantee is likely to escalate after the election, especially given continuing public anger over the TARP program and growing public concerns over the role of the Federal Government. Ultimately, it will fall to Congress and the Administration to decide how to reform the GSEs and whether a federal guarantee will be part of that solution.

The Arguments For and Against a Federal Guarantee

During the recent Congressional hearings, the advocates of an explicit federal guarantee argued that the guarantee is needed to ensure a steady flow of mortgage finance at a reasonable cost to borrowers. SIFMA, for example, offered the following rationale for the guarantee:

> SIFMA believes that without the benefit of some form of government support for conventional mortgage markets, mortgage credit would be less available, mortgage markets would be more volatile, and interest rates on loans higher because fewer investors would be willing to absorb both the credit and interest rate risk. In short, investors would not support mortgage credit equivalent to historic norms thus affecting the supply and stability of such credit. (Testimony of Ken Bensten, SIFMA, before House Financial Services Committee, September 29, 2010)

SIFMA also stated that an explicit federal guarantee on conventional loans is needed to maintain the liquidity of the to-be-announced or TBA MBS markets. The TBA market is used by the lending industry to reduce risks in the origination process and reduce borrowing costs for consumers. It allows borrowers to lock in rates in advance of closing a mortgage loan and permits lenders to hedge the corresponding interest rate risk.

Neither SIFMA nor any other proponent of the guarantee quantified the potential contraction in mortgage lending or potential rise in rates in the absence of a federal guarantee. However, SIFMA noted that the implicit guarantee on GSE MBS "historically reduced the issuance costs for those bonds because it attracted a number of important classes of investors and provided for the development of a large, extremely liquid secondary market."

Other witnesses told the Congress that some government support is needed to maintain broad availability of long-term, fixed rate mortgages. For example, Philip Swagel of Georgetown University stated that "Government involvement is inevitable because a government backstop is necessary to ensure the availability of 15- and 30-year fixed rate mortgage products with no prepayment penalty." (Testimony before the House Financial Services Committee, September 29, 2010) Similarly, Susan Wachter with the University of Pennsylvania noted that "We must remember the reason the

GSEs exist in the first place. Without government support, the long-term, fixed-rate mortgage would not be the dominant form of housing finance in the United States . . . ' (Testimony before the House Financial Services Committee, September 29, 2010).

One witness testified that we would not see the demise of the 30-year fixed rate loan in the absence of a guarantee, but that the 30-year fixed rate loan would become more expensive relative to adjustable rate mortgages:

> Many commentators have said [that the government leaving the guarantee function entirely to the private market] would mean the end of the 30-year fixed rate mortgage. My view is that lenders would likely still offer 30-year terms, but that the prices would fall causing required returns (i.e., mortgage rates) to rise (certainly relative to the traditional spread between fixed and adjustable rate mortgages). Banks could be made more inclined to fund mortgages if more were adjustable rate. (Testimony of Christopher Papagianis, Economics21, before House Financial Services Committee, September 29, 2010)

Critics of the federal guarantee argue that private insurers can step in and provide needed support for investors. Private bond insurers did wrap non-agency MBS prior to the financial crisis. However, as Acting Director DeMarco told the Committee, in the wake of the crisis those insurers "are in very poor financial condition, and their losses may ultimately jeopardize their ability to pay future claims." This may make it difficult for investors to view private sector support as a complete substitute for a federal guarantee.

Critics of the federal guarantee also argue that other countries have equal or higher levels of home ownership without such federal support. Many other developed countries do have higher levels of homeownership (e.g., Australia, Canada, Ireland, Spain the U.K.) and no other country has a GSE like Fannie Mae or Freddie Mac. At the same time, there are significant differences between mortgage instruments in the U.S. and most other developed countries.

These differences were highlighted in the testimony of Dr. Michael Lea before the Senate Banking Committee on September 29th. Dr. Lea is currently with San Diego State University and is a former chief economist for

Freddie Mac. He explained that in most other developed countries mortgage instruments are limited to adjustable rate mortgages and short- to medium-term fixed rate mortgages that reset. In Canada, for example, the typical mortgage has a fixed rate for a period of 1 to 10 years with a longer amortization period. Moreover, borrowers in Canada are subject to pre-payment penalties and lenders have full recourse against all of a borrower's assets in event of a default.

Therefore, it appears that the key to a stable system of housing finance is not the presence or absence of explicit federal support[3], but short-term mortgage instruments and different legal and tax structures surrounding those instruments. In his testimony to the Senate Banking Committee, Alex Pollack of AEI, a critic of GSEs and federal guarantees, acknowledged this conclusion:

> ...the international perspective makes it clear that many countries achieve home ownership levels as high or higher than ours with no GSEs. It turns out that these levels can be achieved without tax deductions for the interest paid on home mortgages, without our very unusual practice of making mortgages into non-recourse debt, without government mandates to make "creative" (that is, riskier) loans, without 30-year fixed-rate loans, and with prepayment fees on mortgages. (Testimony before the Senate Banking Committee, September 29, 2010)

This presents a challenge for policymakers, especially those that wish to limit the role of the Federal Government in housing finance. Are we prepared to move away from long-term fixed rate mortgages, the deduction for mortgage interest, and other legal and tax features of our mortgage finance system?

The proponents of a federal guarantee envision a middle path. They have attempted to design an explicit guarantee that maintains widespread availability of the 30-year fixed rate mortgage (an all its attendant legal and tax provisions), but minimizes taxpayer exposure under the guarantee.

Several features of the proposed guarantee are designed to shield taxpay-

[3]Over half of the conventional mortgages issued in Canada carry mortgage insurance provided by the Canadian government.

ers. First, the mortgages included in the MBS would have to be prudently underwritten; no alt-A or sub-prime instruments could be included in the MBS. This alone would significantly reduce the scope of potential losses on the MBS. Second, the entities that issue the MBS would be subject to stiff regulatory oversight and much higher capital than imposed on the GSEs. Fannie and Freddie held only 45 basis points in capital behind their guarantee business. The successors to the GSEs should hold substantially more capital and that capital would stand before taxpayers.

Admittedly, these two safeguards may not be enough to fully shield taxpayers. As Susan Wachter told the House Financial Services Committee, "We know from experience, however, that there will be great pressure on future regulators to loosen these standards when the market is thriving." (Testimony before the House Financial Services Committee, September 29, 2010) Also, critics of the guarantee can cite the failure of the savings and loan model and the GSEs themselves as examples of lax regulation. Susan Wachter's answer to this problem is transparency:

> Regulators must therefore require originators and securitizers to inform investors of relevant terms of each loan, as well as other risk-related information. (Testimony before the House Financial Services Committee, September 29, 2010)

Proponents of the guarantee also call for even greater levels of protection for taxpayers. All of the proposals that include a federal guarantee feature assume the imposition of risk-based premiums that could be used to build a reserve to stand as an additional level of protection for taxpayers. Additionally, the Housing Policy Council has endorsed an after-the-fact system of assessments in the event the accumulated guarantee fees are insufficient to pay all claims.

Critics of a guarantee would argue, in turn, that any risk-based premium may be mispriced, and they could cite evidence from existing federal insurance programs. They also could argue that the post-event assessment will be of little value if all entities that create the MBS have failed, just as both Fannie and Freddie failed in the recent crisis. These concerns, however, can be addressed. It would be possible to provide for independent verification of the guarantee fee. Also, most proposals envision multiple firms engaged in the creation of MBS, not just two. Sufficient regulatory oversight should prevent the simultaneous failure of all such firms.

Conclusion

Before the debate over GSE reform concludes, policymakers will need to decide whether and to what degree the Federal Government must backstop conventional MBS. Recent Congressional hearings provide some insight into the argument for and against such support. In the end, the answer to this question may depend upon the degree to which policymakers are willing to move toward shorter-term mortgage instruments and the elimination of prepayment penalties. Federal support may not be needed if such a fundamental restructuring of mortgage finance is adopted. If, however, policymakers decide to maintain the current structure, some form of a guarantee would appear to be necessary.

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