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Five Guiding Principles for Housing Finance Policy: A Free-Market Vision

Norbert J. Michel, PhD, and John L. Ligon

The two government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, remain under government conservatorship with the federal government standing behind all of their obligations. Housing finance reform is likely to be addressed during the next congressional session, but it appears the House and the Senate may offer very different reform proposals.

Congress should move the U.S. toward a market-based housing finance system. Increasing government intervention—as U.S. policies have done for decades—only makes housing less affordable for the typical American and destabilizes housing and financial markets. The following is a list of five free-market principles to guide the future housing finance policy debate.

1. Private Investors, Not Federal Taxpayers, Should Bear Financial Risks.

In the 1990s, the U.S. housing finance system morphed into one that was heavily dependent on implied taxpayer guarantees. From 1990 to 2003, Fannie and Freddie went from holding 5 percent of the nation's mortgages ($136 billion) to more than 20 percent ($1.6 trillion). Investors who purchased Fannie and Freddie's bonds and mortgage-backed securities (MBS) provided funds for people to finance homes.

These bondholders and MBS investors enjoyed implicit government backing: It was common knowledge that taxpayers would make good on promised cash flows if either Fannie or Freddie were to ever fail financially. In effect, these investors enjoyed the safety of U.S. Treasury securities with rates of return that were greater than those available on Treasuries.

This feature led to more risky lending than would have taken place without such guarantees. The GSEs' debt and MBS were deemed safe by regulators and were used pervasively throughout the financial system because of these guarantees.

Policymakers should avoid providing taxpayer guarantees—implicitly or explicitly—because doing so leads to excessive risky debt.

2. Private Capital, Not Government Funds, Should Finance the Housing Market.

Robust homeownership was established in the U.S. long before the government became heavily involved in the housing market. From 1949 to 1968 (the year that Fannie Mae was allowed to purchase non-government-insured mortgages), government-backed mortgages never accounted for more than 6 percent of the market in any given year.[1] Yet the homeownership rate was 64 percent in 1968, virtually identical to what it is now.

Borrowers and lenders like to take risk because it provides the possibility of a future financial reward. Shifting these financial risks—the possibility of losing money—onto taxpayers is what causes systemic risk. Policymakers should ensure that private borrowers and lenders accept their own risk–reward

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The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

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tradeoffs. Policies that try to ensure private profits while socializing losses expose taxpayers to losses and increase systemic risk.

3. The Federal Government Should Neither Promote Nor Hinder Homeownership.

The benefits of homeownership can extend beyond the individual to the community. However, it does not follow that the federal government should actively encourage people to purchase homes. The decision to rent or buy a home should not be influenced by government policy. Furthermore, encouraging people—especially those with low wealth—to finance home purchases with low-equity long-term debt makes little sense. Yet these are exactly the types of policies the U.S. government has encouraged for decades with little benefit and, arguably, a major financial crisis and recession to show for it.

In particular, the rate of U.S. homeownership has remained nearly constant over the past 50 years as government intervention has steadily increased, but the level of residential mortgage debt has increased nearly sixfold.[2] Thus, these policies have distorted markets by diverting resources into the housing sector at the expense of other areas of the economy. Two clear distortions from these policies have been artificially higher home prices and lower interest rates.

Housing prices increased dramatically as the GSEs' operations were expanded in the 1990s. At the peak of the housing market in 2006, the national Case-Shiller home price index was 84 percent above its long-term trend.[3] As the market collapse showed, these dramatic increases were not sustainable. Furthermore, even though Fannie and Freddie enjoyed an estimated annual subsidy ranging from about $7 billion to $20 billion, the bulk of this subsidy appears to have benefitted only the GSEs' shareholders and creditors. Research suggests that homeowners may have benefited by paying, at most, 0.50 percent less in interest rates than if there had been no GSE subsidy.[4]

These market distortions have also created the need to continually expand subsidies. Higher housing prices, for instance, provide the political justification for helping various constituents—even renters—to afford housing. Groups as diverse as homebuilders, bankers, investment bankers, and affordable housing advocates have a well-established history of securing policies that favor their members.

4. Private Markets Should Develop Their Own Mortgage Products.

Advocates of federal guarantees argue that the 30-year fixed-rate mortgage (FRM) provides borrowers with long-term security, but they often fail to mention any of the risks associated with these long-term FRMs. These risks exist, however, and government policies tend to shift them from financial markets to taxpayers—thus creating systemic risk. Historically, government policies that favor certain types of mortgage products have contributed to major financial crises.

To deal with specific financial problems that surfaced in the 1920s, government policies simultaneously promoted FRMs and discouraged the use of adjustable-rate mortgages (ARMs) long after the Great Depression. Eventually, policymakers removed ARM lending restrictions as they recognized that a mortgage market dominated by FRMs was not a good match for the volatile inflationary environment of the late 1960s and 1970s. By 1988, ARMs accounted for approximately 60 percent of the U.S. market, nearly the same share currently held by FRMs in the U.S.[5]

1. See John L. Ligon and Norbert J. Michel, "GSE Reform: The Economic Effects of Eliminating a Government Guarantee in Housing Finance," Heritage Foundation *Backgrounder* No. 2877, February 7, 2014, http://www.heritage.org/research/reports/2014/02/gse-reform-the-economic-effects-of-eliminating-a-government-guarantee-in-housing-finance.
2. See John L. Ligon and Norbert J. Michel, "Why Is Federal Housing Policy Fixated on 30-Year Fixed-Rate Mortgages?" Heritage Foundation *Backgrounder* No. 2917, June 18, 2014, http://www.heritage.org/research/reports/2014/06/why-is-federal-housing-policy-fixated-on-30-year-fixed-rate-mortgages.
3. In states such as California and Florida, state home price indices were more than 100 percent above trend. See Norbert Michel et al., "Home Equity Lines of Credit and the Unemployment Rate: Have Unemployed Consumers Borrowed Themselves into the Next Financial Crisis?" *Journal of Banking and Finance* (forthcoming), http://www.sciencedirect.com/science/article/pii/S0378426614002283 (accessed August 4, 2014).
4. Ibid; Ligon and Michel, "GSE Reform," p. 8.
5. Ligon and Michel, "Why Is Federal Housing Policy Fixated on 30-Year Fixed-Rate Mortgages?"

Government policies should not favor any particular mortgage product, because no one product can best serve the needs of every borrower at any one time.

5. Private Property Rights Should Be Respected.

Several lawsuits have complicated the dissolution of the GSEs.[6] In particular, disgruntled private shareholders of Fannie and Freddie have filed suit against the federal government.

The most serious of these claims is that the current practice of "sweeping" all earnings by Fannie and Freddie to the U.S. Treasury is unconstitutional. While this claim is not without merit, it should not be allowed to impede much-needed efforts to dissolve the corporations. Protecting property rights does not mean that taxpayers and consumers must continue to be put at risk by these economically dangerous institutions.

Moving Forward

Free markets promote affordable housing, but the federal government has increasingly intervened in housing finance for decades. Housing finance reform will be successful only if policymakers recognize the flaws of previous interventionist policies and embrace the basic principles inherent in a free market. The broad principles presented here can help shift housing finance away from a highly regulated activity to one that promotes individual economic freedom and affordable homeownership.

*—**Norbert J. Michel, PhD,** is a Research Fellow in Financial Regulations in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom and Opportunity, at The Heritage Foundation. **John L. Ligon** is Senior Policy Analyst and Research Manager in the Center for Data Analysis of the Institute for Economic Freedom and Opportunity.*

6. See James Gattuso, "Taking Stock: Shareholder Lawsuits No Barrier to GSE Dissolution," Heritage Foundation *Issue Brief* No. 4225, May 19, 2014, http://www.heritage.org/research/reports/2014/05/taking-stock-shareholder-lawsuits-no-barrier-to-gse-dissolution.