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"Promising Road" to GSE Reform? We've Been Here Before

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The debate over the future of our mortgage finance system is back in fashion. Sparked by a paper from Jim Parrott, Lew Ranieri, Gene Sperling, Mark Zandi and Barry Zigas, as well as a series of ongoing essays organized by the Urban Institute, commentators are again asking what direction we should go. Parrott et al., title theirs "A More Promising Road to GSE Reform." With all due respect to its authors, a few of whom I consider friends, going down this road would largely take us back to the pre-crisis status quo.

The "Promising Road" proposal is intentionally modest. The "promise" is less about fixing fundamental flaws in our mortgage finance system and more about finding a broadly acceptable path to resolving the current impasse in mortgage finance reform. It is by design pragmatic. I suspect, as a first best, the authors would have all preferred a more dramatic approach.

Their objective is to keep "those components of today's system that work well" while leaving behind those that do not. Unfortunately, the authors confuse which components actually work and which do not. Nowhere is this clearer than in their embrace of an explicit federal guarantee on mortgage-backed securities.

Mutualizing risk, whether via the private or governmental sector, entails both moral hazard and adverse selection. A considerable amount of effort in finance and insurance is devoted to addressing such, with some success. Parallel efforts in government have been less successful, if not outright failures. There's probably no better example of a failed government attempt to mutualize risk than flood insurance. Not only is it deeply in debt from an unwillingness to charge sufficient rates, it also encourages environmentally destructive building patterns.

If the government explicitly guarantees MBS, investors will not care about the credit quality of mortgages. From conversations with at least one of the authors, that is a goal of this plan: for investors to not care. One thing we should have learned from the crisis is that when investors don't care about credit quality, we get poor quality loans. The proposal is guaranteed to produce poor quality mortgages. That may well be an actual objective of the proposal.

We are assured that quality will not suffer as loans will be tied to Dodd-Frank's Qualified Mortgage requirements. What's left unsaid is that the QM requirements put no restrictions on the loan features that were the primary drivers of the crisis: borrower credit and equity.

While the authors throw around empty phrases like "creditworthy," the facts are that this system would still have the government encourage, without needed safeguards,the extension of low down-payment mortgages to subprime borrowers. A loan with 3% down to a borrower with a

FICO score of 580 is not a "low risk" loan. It is likely that no such loan would ever be made without a government guarantee.

And of course a 780 FICO with 10% or more down will continue to be made without any government guarantee. Advocates of simply re-building the status quo should be more transparent about their ultimate objective.

Now one could hope, as do the authors, that regulators — in this case FHFA — would take appropriate actions to offset the moral hazard created by the guarantee. To do so would be to ignore almost the entire history of financial regulation. Crowding out market discipline with government regulators has been a disaster.

There are a number of other flaws to the "Promising Road" proposal. Claims about "lower cost" are driven by cherry-picked assumptions. Supposed benefits are largely driven by the extreme leverage of their preferred system. If there's one thing we should have taken away from the financial crisis, it's recognition of the extreme dangers inherent in this sort of leverage. Setting required capital equal across proposals eliminates much of this difference, as does realistic assumptions on the cost of capital.

The proposal also mischaracterizes the pre-2008 system. For instance "interest rate and noncatastrophic credit risk" were already borne by the private sector. Those who hold agency MBS already bear the interest rate risk. Government-sponsored enterprise equity holders bear the noncatastrophic credit risk. Much of what this proposal claims to achieve was already the case pre-2008 and didn't work well then.

We know how mortgage lending can work without government guarantees behind the mortgage backed securities market. Look at the auto loan automobile-backed securities market. Look at the jumbo market. Look at the rest of the world. Our current system of mortgage finance is fundamentally flawed. It has not delivered sustainable increases in homeownership. It has not delivered financial stability (obviously). It has left homeowners drowning in debt and driven house prices beyond the reach of the middle class. We should stop driving in circles trying to tweak the status quo. If that means being less pragmatic, then so be it. There is simply too much at stake to settle for anything other than fundamental reform, whether such is politically promising or not.

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