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Economic Impact of a Privatized System of Housing Finance*

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The Administration has presented a report to Congress that outlines three alternatives to Fannie Mae and Freddie Mac. One of the alternatives is a privatized system of housing finance in which the government's role would be limited to a narrowly targeted group of borrowers served by the FHA, USDA, and the Department of Veterans' Affairs.[1] This privatization option has received support from the editorial pages of the Washington Post and the Wall Street Journal. Both newspapers note that privatization would reduce distortions in the financial markets and cause capital to flow to more productive sectors of the economy. It also would reduce taxpayer exposure to housing.

Do these benefits of a privatized system outweigh the impact on the cost and availability of housing finance? A recent paper by Mark Zandi of Moody's Analytics provides some insight into this question.[2]

The paper, which is entitled "The Future of the Mortgage Finance System," starts with an overview of what went wrong with the current system of mortgage finance. The paper acknowledges that "This was not supposed to happen." Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the Federal Housing Administration were intended to prevent "wild swings" in the housing market. Yet, during the past decade the housing market went from boom to bust. There are many factors that contributed to this problem, and the paper outlines several, including huge capital flows into the U.S., the growth of securitization, and regulatory and industry mistakes. The paper

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[1]The other options presented in the Administration's report are privatization plus a guarantee mechanism for the Federal Government to stabilize markets during times of crisis (option 2), and privatization plus a form of catastrophic federal reinsurance behind mortgage backed securities (option 3).

[2]A copy of this paper may be found **here**.

then evaluates three approaches to reform, including a privatized system of housing finance. The paper defines privatization to mean the elimination of any federal support for the secondary conventional mortgage market, either implicit or explicit, except for FHA. This is fundamentally the same as the privatization option presented in the Administration's report to Congress.[3]

Like the Administration's report, the paper notes that privatization would lead to a transfer of capital from the housing sector to other sectors of the economy. It also would reduce the taxpayer exposure to housing. On the other hand, the paper suggests that a privatized system could become more concentrated given scale economies in mortgage lending and servicing, and this could increase too-big-to-fail risks and leave the government little choice but to step in and support the system during crisis periods. Moreover, the paper suggests that a privatized system could not provide stable mortgage funding during periods of financial stress. This certainly was the case during the recent housing crisis.

As for consumers, the paper states that the 30-year fixed rate mortgage would be less available under a privatized system. Since 1985, fixed rate mortgages have constituted approximately 75 percent of all consumer mortgages. Under a privatized system, however, adjustable rate mortgages would become the norm. The paper states that, in a privatized system, only 10 and 20 percent of all mortgages would be fixed rate mortgages. In other words, while most consumers currently select fixed rate mortgages, only a small minority of borrowers would be able to do so in a privatized system. Additionally, nonprime borrowers would find it difficult, if not impossible, to obtain any type of mortgage loan under a privatized system. They would need to look to FHA and the VA for mortgage finance, or simply rent rather than buy.

The paper also notes that consumers would face higher mortgage rates under a privatized system. Assuming capital requirements in the private system are set to absorb a 25 percent decline in housing prices, mortgage rates would increase somewhere around one percentage point over current rates.[4] The paper notes, however, that this rate projection is conservative

[3]The other options discussed in the Zandi paper are nationalization, and a "hybrid" system of privatization plus catastrophic federal reinsurance. This latter option is similar to the Administration's option 3.

[4]The paper calculates guarantee fees based upon different potential capital requirements. The size of the guarantee fee translates directly in the rate paid by consumers on mortgage loans. Assuming private firms must hold capital to support a 25 percent drop

since it does not reflect legal or other constraints on institutional investors, which would narrow the range of potential investors and cause even greater increases in applicable rates. In other words, if the pool of investors shrinks, mortgage rates could increase well beyond one percentage point in a privatized system.

Finally, the paper provides some insight on the impact on the housing market and homeownership rates. It concludes that under a privatized system, we would see 375,000 fewer home sales per year and the homeownership rate would drop by at least one percentage point.

In summary, the paper finds that under a privatized system of mortgage finance, capital would flow from the housing sector to other sectors of the economy and taxpayer exposure to housing would be reduced. In exchange for these benefits, however, the mortgage lending industry likely would be more concentrated and less able to ensure a stable supply of mortgage finance in stressful economic periods, most consumers could no longer obtain a fixed rate mortgage, nonprime borrowers would have to look to FHA and VA for mortgage finance, mortgage rates would increase by roughly one percentage point and possibly more if investors leave the housing finance market, and we would see a decline in both housing sales and homeownership rates. Is this an exchange we are prepared to make?

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in housing prices, the guarantee fee in a private system would be 96 basis points greater than the fee in a nationalized system, and it would be 87 basis points higher than the fee in a hybrid system.