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Comment Susan M. Wachter

Authors Jaffee and Quigley focus their chapter on an analysis of federal programs that provide insurance and housing credit guarantees. After a description of a variety of federal government programs, including the federally-chartered government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, they concentrate specifically on the changes and challenges to the mortgage insurance and guarantee programs managed by the Federal Housing Administration (FHA). They offer specific, policy-oriented recommendations to bolster the FHA's declining market share.

After the Great Depression, the FHA pioneered the introduction of the thirty-year self-amortizing fixed rate mortgage, the standard mortgage that prevailed in the United States for decades. The FHA and Fannie Mae, and its predecessor the Home Owners' Loan Corporation (HOLC)—a federal entity—succeeded in reviving a mortgage market then in collapse due to the prevalence of "bullet" loans. After World War II, loans insured by the FHA lost market share to similarly structured nongovernment or "conventional" loans. The FHA's role evolved to serve lower income households who lacked the 10 percent down payment required by the conventional prime market. With the explosion (now implosion) of subprime over the past decade, FHA's market share decreased even further until 2008 when, in response to the collapse of subprime, FHA market share increased to its current 25 percent level. The ongoing subprime mortgage market crisis (similar to the Great Depression, centered on loans that require refinancing at a time when financial markets seize up) makes the role of the FHA newly relevant.[1]

A large segment of the Jaffee and Quigley chapter is devoted to a comprehensive and very useful description of all federal housing programs. The chapter sets out an historical and contextual analysis of the evolution of housing programs over time, pointing to the elimination of supply-side public housing in favor of demand-side housing vouchers. The chapter contrasts this—and other directly funded programs that have lost federal support—with the growth of programs indirectly funded through federal tax expenditures, including the homeowner deduction and the low income

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1. For additional discussion on the FHA, see Green and Wachter (2007).

housing tax credit. Direct federal funding for all housing programs has declined significantly over time. Why is this so? What have we lost or gained? The authors do not take on these questions or the overarching question of what is the appropriate role of federal government in housing. Such a perspective might have helped as they transition into conclusions for the programs which they do delve into in more detail.

The major part of the chapter is focused on federal support for housing credit. After a description of the history of the GSEs, the authors take on the controversy of the source of GSE funding. They soundly come down in favor of funding with pass-through securities with limits on portfolio lending rather than through expanded portfolio lending. They point out that taxpayers bear contingent liability for the latter if the GSEs take on interest-rate risk. The Office of Federal Housing Enterprise Oversight (OFHEO) did in fact put retained mortgage portfolio limits in place, in part in response to the GSE's accounting difficulties; only to lift these as the mortgage market deteriorated in 2008.

The authors also take the position that the implicit subsidy received by the GSEs could be better "spent" from a distributional perspective if the GSEs were forced by lower conforming loan limits to lend to a lower income portion of the market. Recent legislation has lifted conforming loan limits.

In the aftermath of the subprime crisis, legislators have looked to the GSEs as well as to the FHA to expand their roles. The authors argue for an expanded role for the FHA and for a more limited role for the GSEs. It may be that now is the time to rely on the FHA and Ginnie Mae, which securitizes FHA mortgages. Nonetheless, it would have been useful for the authors to take this question on explicitly. These institutions and their markets are linked and both the FHA insured mortgages and the GSEs' "agency" mortgage-backed securities (MBS) market have secure funding sources, an important distinction, given the seizing up of the private sources of "private label" funding for subprime mortgages. Moreover, except for the discussion of interest rate risk, the authors do not directly take on the question of burgeoning mortgage default risk and how it relates to the growth of the subprime market and the private label mortgage-backed securities market and the market for MBS derivatives, Collateralized Debt Obligations (CDOs). Nonetheless, the authors are prescient in their implicit reliance on government guaranteed FHA rather than on the Fannie/Freddie model, since, through conservancy, they have become government guaranteed mortgage companies as well.

The authors' recommendations are timely because they offer their view of what long-term policy dealing with subprime should be. The essence of their recommendation is to expand the FHA's market share by reshaping the FHA to take on some aspects of the subprime market, in order to allow the FHA to compete with this market. To understand the impact of this policy suggestion, it is useful to point to the key differences in these two mortgage markets as currently designed.

Subprime mortgages are designed for borrowers with impaired credit records. Unlike FHA insured and GSE guaranteed mortgages, subprime mortgages "price" risk. On the other hand, for borrowers who meet the risk thresholds of the FHA and the GSEs, a more or less uniform mortgage rate is charged for accepted loans. That is, risk-based pricing is limited and lower risk borrowers cross-subsidize higher risk borrowers.

The authors attribute the decline in FHA loans to four factors: subprime lending, predatory lending, GSE competition, and the failure of the FHA to offer innovative mortgage products. The developments that they point to as helping conventional markets are advances in underwriting technology and growth in private mortgage securitization, in addition to GSE market share growth.

The simple explanation for the FHA decline in market share, however, is apparent in the graph shown in figure 5C.1: FHA market share declined as subprime market share grew (GAO 2007). Why subprime took market share away from the FHA is not directly addressed. Two obvious explanations are that subprime lending criteria were liberal to nonexistent and that short-run mortgage payments (before teaser rates adjusted) were lower and more "affordable."

The authors offer a normative policy analysis and a fundamental repurposing of the FHA. The new purpose in short is "to counter the growth of subprime and predatory lending associated with subprime." They suggest that an aggressive and innovative loan demonstration by the FHA can be an efficient means of redressing the extent of predatory lending, especially to lower income clientele.

To do so, they propose legislation that would enable the FHA to develop mortgage contracts that would offer competitive terms to those attracted to the subprime market, but also eligible for FHA funding. The authors mention the incorporation of innovative tools, including teaser rates, as well as risk-based pricing. In order to assist borrowers who are unaware of alternatives and therefore are subject to predatory pricing, the authors recommend that the FHA offer one or more alternative mortgages for consideration at least several days before a scheduled house closing; the terms of the mortgage would be transmitted to the borrower in a side-by-side format, which compares the FHA mortgage to the subprime mortgage being offered. Mortgage contracts would not be enforceable unless the borrower household explicitly rejected the FHA mortgage in favor of the private, subprime mortgage. The authors couple this policy approach with an additional recommendation that mortgage lenders be required to abide by a duty of suitability similar to the system upheld in the stock-broker industry. Together they believe these requirements would be a powerful deterrent to predatory lending. They argue that this approach could militate against informational

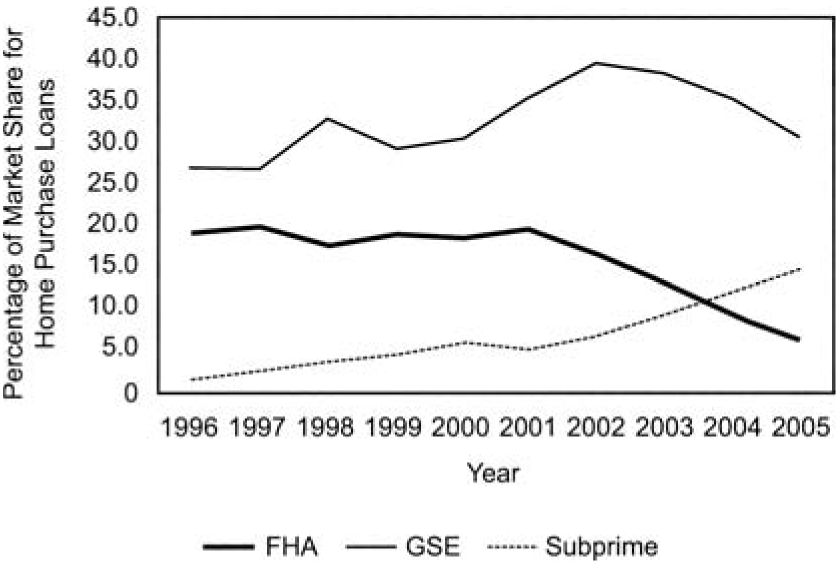

Fig. 5C.1 Market participants' share of home purchase mortgage market: 1996 to 2005

Source: Government Accountability Office (2007).

asymmetry, particularly for inexperienced borrowers who are unaware of alternative, more beneficial mortgage contracts for which they also qualify. The authors thus suggest that the best way to redress asymmetric information for the buyer is to create a standardized FHA loan comparable to subprime and require that this loan be disclosed by all lenders extending loans to lower income clientele.[2]

While of great value, such a recommendation raises questions, especially in light of the subprime crisis. If the FHA were really to compete would it have to offer the teaser rate adjustable-rate mortgages (ARMs) that have been at the center of the subprime crisis and arguably were a major source of the growth in subprime and loss of FHA market share? It may very well be that the growth of these loans, in particular, allowed subprime to outcompete the FHA, since these loans were affordable in a period of rising housing prices, when other loans were not.

Or let us assume that such loans are ruled out because they could not meet a standard of suitability.[3] Would the FHA's role be to match the subprime

2. The authors' suggestions are similar to those given in Barr, Sendhil, and Shafir (2008), where it is argued that borrowers should be presented with an "opt-out mortgage plan" to mitigate the problem of asymmetric information. Borrowers would receive a standard set of mortgages with easily understandable terms and strong underwriting. A borrower would then have to explicitly "opt-out" of the mortgage if they chose not to participate.

3. For a discussion on the relative benefits of suitability versus a standard, see Wachter (2003) and Engel and McCoy (2002).

market's pricing for allowable loans? But of course the subprime loans that were being made during the run-up to the mortgage crisis were not fully pricing risk. Subprime loans were higher risk without bearing sufficiently higher return to cover the risk.

If the FHA had gone this way, it would have required immediate taxpayer support and a bailout, undermining the current circumstances under which the FHA has been used as a platform to assist the struggling mortgage market and borrowers in distress. The history of financial markets suggests that episodes of mispricing and underpricing of risk are not avoidable. Markets appear to be backward-looking in terms of their assessment of risk. In good times risk is assumed to be low and after a crisis, risk is reevaluated and lending rates spike. The subprime lending industry appears to have followed this pattern. Going forward, should the FHA attempt to compete and follow market-pricing patterns? If it does not, then these parallel mortgages will be irrelevant, and once again the FHA will lose market share. If it does then the FHA too will be subject to mispricing, adding to market volatility.[4]

The ultimate questions are how much risk and volatility do we want in our mortgage finance system? Wall Street will price any risk and procyclically misprice risk, especially in the absence of price discovery mechanisms. The private label securitization system discouraged standardized, liquid MBS and CDOs that would have enabled short sellers to trade and to take the other side of bets that were wrongly made. Investors in these instruments took on great risk, which was not compensated by higher required returns. When they did so, they also exposed borrowers and the overall economy to increased house price volatility and risk. Such lending financed through MBS, even with diversified loan portfolios, is entirely exposed to systemic risk. Negatively amortizing and teaser rate mortgages that require refinancing to avoid certain default have risk that is correlated, engendering systemic risk similar to that created by the mortgages prevalent during the Great Depression. The procyclical easing of lending standards and underpricing of risk is an endemic problem, not likely to be corrected by the useful but limited solutions put forth here.

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4. For discussion and evidence on why and how markets with nonrecourse lending tend to underprice risk, see the following references: Abraham, Pavlov, and Wachter (2008); Green et al. (2008); Green and Wachter (2007); Pavlov and Wachter (2008, 2006, and 2009); and Wachter (2003).

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