A Three-Part Program for Housing Finance Reform

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Shadow Open Market Committee Meeting
October 12, 2010

During the 1990s and 2000s leverage tolerances on US government-guaranteed mortgages rose steadily and dramatically at FHA, Fannie Mae and Freddie Mac. The average loan-to-value (LTV) ratio of FHA mortgages rose to 96 per cent, and a third of Fannie and Freddie's purchases leading up to their insolvencies had LTVs of greater than 95 per cent.

Without high leverage the subprime boom and bust could not have happened. Risky no-docs borrowers would have been unwilling to deceive lenders if they had to pledge a large amount of their own savings as a down-payment (deposit). House price declines would not have produced huge loan losses if homeowners had retained a minimum 20 per cent stake in their homes.

Not only are high LTVs destabilizing, they undermine the objectives of housing policy. Its central goal is promoting stronger communities by encouraging residents to have a stake in them. But a 97 per cent LTV creates a trivial stake; homeowners become renters in disguise, able to abandon homes at little cost.

How do we get rid of destabilizing subsidization of mortgage risk while still making it possible for lower-income people to become homeowners?

I propose a three-part plan for redesigning housing finance: Firstly, replacing leverage subsidies (and phasing out Fannie Mae, Freddie Mac, and FHA mortgage guarantee programs) with means-tested down-payment assistance alongside reduced LTVs; secondly, offering means-tested interest rate risk assistance; and finally allowing means-tested, tax-favored savings accounts for would-be homeowners.

An obvious alternative to subsidizing mortgage risk is subsidizing down-payments. This is the approach of Australia's (non-means tested) housing policy, which gives A$7,000 to all first-time home buyers.

An improved variant would offer means-tested subsidies for first-time home buyers, while also phasing in increases in minimum down-payments. For example, first-time home buyers with houses worth less than a (regionally adjusted) maximum, who earn less than a maximum family income, would be eligible for a lump sum housing grant equal to the smaller of, say, $10,000 or 30 per cent of the down-payment on their home.

Minimum down-payments on all mortgages would rise by one per cent a year over 17 years to the new minimum of 20 per cent. This rising minimum should apply to all mortgages, not just those of buyers receiving explicit assistance. Recipients of down-payment assistance would pay no interest on their grants. The assistance would take the form of a junior equity lien on their homes (senior to their own equity investments, but junior to mortgages). Principal would be repaid in full upon sale or refinancing of the house.

Some observers have argued that the private sector is unwilling to provide affordable long-term fixed rate financing without a government subsidy. Those arguments ignore the reason that the private sector has been slow to compete in the mortgage market, namely the huge government subsidies for leverage that have crowded out private providers. Once the government allows leverage to return to normal, private entry, including in long-term, fixed rate mortgage lending will follow.

Nevertheless, an argument can be made for assistance to low-income borrowers to pay the higher interest cost of a long-term, fixed rate mortgage. Reducing the cost of locking in a long-term fixed rate is of particular importance to low-income households, who have less ability to absorb the burden of rising

interest rate payments. That rationale motivates the second part of my plan for supporting affordable housing. Rather than provide invisible interest rate subsidies through FHA, Fannie and Freddie, the government should subsidize low-income buyers of privately supplied mortgage interest rate swaps (limiting the subsidy to, say, to the lower of $5,000 or 30 per cent of the cost of the swap).

Tax-favored treatment of savings accounts that could be used by low- and moderate-income families to accumulate adequate down-payment would further encourage “skin in the game.” Given that low-income Americans pay little or no income tax, it may be desirable to allow some reduction in payroll taxes on funds placed into “Home Savings Accounts.”

The small costs (relative to current programs) of these proposals include: the time value of money and losses from default on down-payment assistance, the cost of swap subsidies, and foregone payroll taxes. All these costs should be recognized explicitly on the government’s budget. These programs would replace existing implicit mortgage risk subsidies provided through FHA, Fannie and Freddie. FHA mortgage guarantees would end, Fannie and Freddie’s assets would be sold into the market, and Federal Home Loan Banks would also be phased out.

Some argue that current housing distress makes it unwise to begin the process of deleveraging at this time, but my proposed reductions in LTVs would be phased in over many years. Others will wrongly argue that we need to preserve FHA, Fannie and Freddie to assist in foreclosure mitigation; to the extent that the government wishes to subsidize the write downs of mortgage debt service to avoid foreclosures, it can do so on budget with explicit loss-sharing.

And, of course, developers will complain that deleveraging will limit the appreciation of house prices, but developers’ self-interest should not obscure the fact that improved affordability of homes is an advantage to homeowners.

Homeowners and taxpayers would both be winners from housing reforms based on targeted subsidies and budgetary transparency, and the reform process should not be delayed.