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How to Privatize the Mortgage Market

Europeans manage just fine without Fannie and Freddie-type agencies.

By DWIGHT M. JAFFEE

Despite the Dodd-Frank financial reform enacted in July, the mortgage market remains frozen and effectively nationalized. Today 90% of the $14 trillion in outstanding residential mortgages is controlled by the Federal Housing Administration (FHA), the Department of Veterans Affairs, or Fannie Mae and Freddie Mac—with the latter two under government conservatorship.

The solution? Privatize the mortgage market.

Fannie and Freddie have shown how government guarantees lead to dangerous risk- taking in which shareholders reap the profits but taxpayers pay for the losses. Even their most powerful longtime congressional patron, Barney Frank (D., Mass.), now agrees it is time to abolish these two government-sponsored enterprises (GSEs). Unfortunately, a popular fallback position is for the government to guarantee every middle-income residential mortgage directly. While that's arguably better than guaranteeing the GSEs, the underwriting standards for government-guarantee programs will assuredly collapse under political pressure, leaving the taxpayers once again holding the mortgage losses.

Our goal today must be to allow home prices to stabilize at affordable levels and to allow mortgage rates and underwriting standards to reach safe, sustainable levels. Government interventions to lower mortgage rates or boost house prices only delay the necessary adjustment, while possibly creating the foundation for a future crash.

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The evidence is strong that private markets can provide the necessary supply of credit to sustain active housing markets. Virtually every European country has well-functioning private mortgage markets without government interventions of the Fannie or Freddie sort, or direct mortgage guarantees.

Despite the world-wide financial crisis and economic downturn, moreover, private European mortgage markets today have delinquency and foreclosure rates that round to zero. European lenders, borrowers and taxpayers all recognize that high underwriting standards obviate the need for government bailouts.

We can create a sound and vigorous private mortgage market in the United States, but no private market can compete with the government-guaranteed and subsidized markets of today. So how do we get from here to there?

First, the government should set a schedule to lower the maximum amount of a mortgage loan that Fannie or Freddie can hold or securitize by a fixed amount each year—say $75,000. As its loan size limits decline, so will the GSE market share, until it reaches zero and the market is effectively privatized. With a government exit plan announced in advance, private lenders have time to expand their loans.

It's possible that this transition plan could go awry—some new economic disaster cannot be ruled out. But we already have an FHA program that insures lower-income mortgages, and a Government National Mortgage Association (GNMA) program that securitizes them. It is highly unlikely, but if the private market of lenders and investors fails to materialize for any reason, it will be simple to expand the FHA to provide temporary guarantees for middle-income mortgages and to expand GNMA to securitize them.

A broader menu of choices would be one benefit of a privatized U.S. mortgage market. European countries offer fixed and adjustable rates, with and without prepayment penalties, alternative amortization periods and so on. There's no reason we couldn't also have a wider variety of choices than at present. The 30-year, fixed-rate mortgage might well remain a favorite of U.S. lenders and borrowers, but only by competing in terms of costs and benefits on a level playing field with other mortgages.

Full disclosures and related consumer protections are crucial. Europe already has these protections, and the U.S. is well along this path, thanks to the Federal Reserve's July 2008 additions to the Truth in Lending Regulations, along with various actions taken and pending by the Department of Housing and Urban Development.

Probably the most divisive issue will concern "recourse"—the provision in a mortgage in which lenders retain the right to take a homeowner's personal assets other than his house in case he defaults on his loan. Recourse lowers European default rates and thereby mortgage rates. It may be difficult to get Americans to accept personal responsibility for mortgages in exchange for lower rates. Considering the colossal damage done in the last few years to the U.S. housing market, and the American aspiration for homeownership, it is surely worth the effort.

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