The Role of the GSEs in the Mortgage Market:

Supporting Homeownership and Financial Stability

For presentation to Hearing of the:

Committee on Banking, Housing, and Urban Affairs
U.S. Senate
Washington, D.C.
on

February 10, 2005

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Chairman Shelby and distinguished members of the Committee:

Thank you for the invitation to testify today on the role that government-sponsored enterprises play in our nation's housing finance system. I am Susan M. Wachter, the Richard B. Worley Professor of Financial Management and Professor of Real Estate and Finance at The Wharton School of the University of Pennsylvania. Formerly, I served as Assistant Secretary of Policy Development and Research at the U.S. Department of Housing and Urban Development. My testimony is based on studies that I and others have authored on the affordability of housing and government-sponsored enterprises and the role of the GSEs in strengthening the American housing finance system.

The major point that I would like to make in my statement this morning is that the current housing finance system we have today increases homeownership, and it does so in a way that strengthens the stability of the macro-economy and the financial well-being of America's homeowners. In today's global economy, the ability to access international capital markets, and, in particular, long term capital, is critical to the support of homeownership and financial stability, and the role of government-sponsored enterprises is key to these outcomes.

In our current housing finance system, thirty year fixed rate mortgages are available whenever and wherever they are needed. This protects families from unexpected interest rate increases. Homeowners can refinance their mortgages, inexpensively and easily, enabling homeowners to enjoy the benefit of falling interest rates. This enhances the overall stability of the economy by supporting demand during downturns. Perhaps most importantly, the benefits of homeownership are extended to lower income and minority households through the availability of low down payment mortgages, helping to open the door of homeownership to more low and moderate income families.

The efficiency of our system has been advanced by the Federal chartering of government-sponsored enterprises (GSEs), in particular Fannie Mae and Freddie Mac. These institutions have enabled the securitization and the development of a secondary market for the funding of mortgages. Securitization and the efficient trading of mortgages in secondary markets have integrated the U.S. mortgage market into the international financial system.

The goal of the Federal chartering of Fannie Mae and Freddie Mac, further articulated by the 1992 regulatory legislation that established OFHEO, is to achieve public policy objectives, including the promotion of nationwide homeownership through the purchase and securitization of mortgages. The Federal government provides a number of economic privileges to the GSEs, most important of which is the implied Federal government guarantee which decreases the enterprises' funding costs. Given the contingent liabilities to the U.S. taxpayer, GSEs are and must be monitored for their safety and soundness, as well as for their mission achievement.

Today, I will first address the increased access to homeownership for all Americans and, in particular, for the underserved, which, I believe, is assisted by the Federal chartering of the GSEs. In my testimony, I will refer to several research papers authored by myself and colleagues. The first set of papers details the extent to which affordable lending products advance homeownership. Second, I will discuss the role of the secondary market and the GSEs in stabilizing credit flows over the course of the credit cycle, and, in particular, the role of the GSEs in the recent strength of the U.S. housing market which has contributed to the stabilization of the overall U.S. economy.

Based on my research and that of my colleagues, Fannie Mae and Freddie Mac have contributed to the expansion of homeownership in America, providing affordable residential mortgages for low- and moderate-income households who otherwise might not have the opportunity to become homeowners. In particular, the GSEs are assisting in overcoming the barriers to homeownership that are particularly difficult for low- and moderate-income and minority families to bridge.

Given the important role that homeownership plays for households and communities, overcoming barriers to homeownership is an important social and public policy goal. This is especially true in the case of minority and lower-income communities, many of which have struggled to build and maintain the wealth and stability that homeownership has been shown to confer.

Researchers have studied the extent to which borrowing constraints, which include income, wealth, and credit quality limitations, have prevented households from becoming homeowners. This research has identified insufficient wealth as the biggest barrier for homeownership (Linneman and Wachter, 1989; Haurin, Hendershott, and Wachter, 1997; Quercia, McCarthy and Wachter, 2003). Researchers have also examined the role of constraints in limiting home ownership for minorities and lower-income households. Wachter et al. (1996) and Quercia, McCarthy, and Wachter (2003) demonstrate that income, and in particular wealth, constraints are a significant impediment to homeownership for "underserved" groups in the population, including younger families, low-income individuals, and especially, minority households. Two more recent studies, Rosenthal (2002) and Barakova, Bostic, Calem, and Wachter (2003) (BBCW below), explicitly quantify the importance of poor credit quality as a barrier to homeownership. These studies provide evidence that credit quality is becoming an increasingly important barrier to homeownership.

BBCW distinguishes among the effects of income-based, wealth-based, and credit-based constraints and tracks how the impact of each type of constraint evolved during the 1990s. BBCW finds that in 1998, the homeownership rate among recent movers would increase by 10 percent if those households with poor credit quality had had unblemished credit records. This compares to a 6 percent increase for a comparable experiment in 1989. Thus, for this population, the importance of credit quality constraints nearly doubled during the 1990s, reflecting an increase in the proportion of households with poor credit quality. At the same time, BCCW finds that wealth constraints, while continuing to be the predominant barrier to homeownership, have become less so.

Indeed, the GSEs have expended a substantial effort to provide "affordable lending" products in recent years. The increased prevalence of these products, which are designed to be more accessible to households with relatively limited means in terms of income and wealth, has coincided with declines in the importance of income and wealth constraints as documented by BCCW.

GSEs have helped to provide "affordable lending" importantly through lower mortgage and down payment rates that exist due to the presence of GSEs, and also through their special affordable lending programs. The results of Quercia, McCarthy, and Wachter (2003) indicate that affordable lending efforts increase homeownership opportunities overall and for underserved populations in particular. Affordable lending products, including those which permit low down payments, have large impacts on the homeownership outcomes of all Americans and larger impacts for underserved groups, including a 27 percent increase in the relative probability of homeownership for young households, a 21 percent increase in the relative probability of homeownership for African Americans, and a 15 percent increase for households residing in central city.

Other research provides evidence that the GSEs have been important to enhancing access to mortgage credit in underserved areas. Bostic and Gabriel directly test for the impact of GSE loan purchases on neighborhood homeownership rates. They find that in census tracts with below median incomes (between 80 and 90 percent of area median family income), GSE-targeted census tracts show higher homeownership rates and lower vacancy rates, especially in less regulated and less supply constrained metropolitan areas. Moreover, Ambrose and Buttimer (2004) report similar findings for rural areas.

Thus, efforts by Freddie Mac and Fannie Mae have helped to advance gains in overall homeownership rates and in homeownership rates among minority and low-income households occurring over the past decade, resulting in the record high homeownership rate in America of 69% in the third quarter of 2004. This evidence of a decline in the importance of financial constraints is consistent with evidence that homeownership rates improved during the 1990s. According to the U.S. Census, homeownership rates surged during the decade, from 64% in 1990 to 69% today.

The gains in homeownership are attributable in part to improved credit risk management, which has enabled the lowering of down payments. Thus, it is not just lower mortgage rates, but also the technical innovations, such as automated underwriting, developed by the GSEs in the 1990s that are responsible for increasing homeownership.

The GSEs and a strong secondary market deliver a second benefit, besides expanded homeownership opportunity, to the American consumer, the standard American Mortgage. The United States has a unique and ubiquitous financial instrument:

the long-term, fixed-rate, self-amortizing, prepayable mortgage. While Americans take this mortgage instrument for granted, it is not available around the globe. The unique characteristics of the U.S. mortgage provide substantial benefits for American homeowners and the American economy. Essentially access to this instrument completes America's households balance sheets, allowing consumption smoothing over the lifetime of consumers and over the business cycle.

In our strong economy with rising home prices, there are increasing concerns about potential predatory practices and the potential for equity stripping that accompanies such practices. Even in the absence of such practices, teaser rates used in pricing to entice borrowers, and evidence that there is considerable myopia in the choice of mortgages of lower rate variable rate mortgages, particularly among more less educated more vulnerable borrowers raise concerns. The importance of the GSEs attention to anti-predatory practices as a component of the standard mortgage is particularly important. The standardized fixed rate mortgage instrument, delivered by the GSEs, clearly has benefits to consumers.

Mortgages in other developed countries have some of the features of a U.S. mortgage, but do not provide these benefits. In the United Kingdom, for example, variable-rate mortgages (VRMs) dominate and typically VRM rates change at the discretion of the lending institution. This system causes homeowners to bear significant interest rate risk, one for which they are not particularly well suited, and places homeownership and household balance sheets at risk in the event that interest rates spike. Such potential spikes even limit the utility of monetary policy and are a source of great concern in the UK.

The long term prepayable fixed rate mortgage protects the American household and economy against interest rate spikes and the prepayment option allows consumption smoothing when rates drop. Unlike in America where home owners can refinance their mortgage, this is either prohibited or costly in the economies of Europe so home owners are unable to benefit from falling interest rates.

The American Mortgage – the long-term, fixed-rate, freely prepayable conventional mortgage – is the mainstay of the home mortgage market because of the activities of Freddie Mac and Fannie Mae. Research has demonstrated that this loan product helps to stabilize house price growth and also macroeconomic growth. The International Monetary Fund issued a cross-country analysis that showed that nations with more fixed-rate lending also enjoyed more stable house prices. And David Miles, in a study prepared for the United Kingdom Treasury, found that establishing long-term fixed-rate mortgage lending in the UK would promote more stable economic growth over time. Joe Peek and Jim Wilcox have also found that GSEs have helped to stabilize credit flows to the residential mortgage market, helping to moderate U.S. business cycles.

This pivotal effect is even more evident in the recent role housing has played in stabilizing the overall U.S. economy. The role of mortgage market access to global capital markets as an automatic stabilizer for the U.S. economy is demonstrated by the strength of the housing sector and its role in moving the economy out of the 2001 recession. Access to international capital markets during a period of low and falling interest rates and possible deflation has resulted in additional consumer spending which has supported the U.S. economy. This benefit that the GSEs and secondary markets provide the American consumer is a major contributory factor to the strength of the America's economy today and to the long-run stability of America's economy going forward.

Chairman Shelby and distinguished members of the Committee, this concludes my prepared statement, and I would be pleased to respond to any questions that you may have.

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