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VIEWPOINT

Subprime Lending Returns: This Time with Explicit Government Support

STEPHEN K. LEECH, CFA | 3 JANUARY 2019

"One of the great mistakes is to judge policies and programs by their intentions rather than their results."
– Milton Friedman

The myriad causes of the Great Financial Crisis (GFC) are now familiar to most everyone. Loose lending, underappreciated investment risks, fraudulent underwriting, mandates for ever more affordable housing, poorly calibrated credit models, and the presumption that housing prices simply could not fall, combined to form a bubble of epic proportions in both the lending and housing markets. This perfect storm for a housing collapse ultimately came to fruition, bringing about the GFC and miring the globe in a deep and long recession. To prevent a future economic crisis, lending standards were initially ratcheted upward, while regulation of mortgage lending and the U.S. Banking system increased. Furthermore, the government placed the two struggling Government Sponsored Entities (GSEs), Fannie Mae and Freddie Mac, into conservatorship. As private lenders at the center of the GFC went out of business, the GSEs in concert with Ginnie Mae, provided over 90% of all single-family home loans immediately after the housing crash, making the federal government the "only game in town" for home mortgage finance (Figure 1, page 2). Due to the increase in risk awareness and a changing regulatory dynamic, it is tempting to believe that today we are in a more responsible lending environment where home loans are granted nearly exclusively to borrowers with sufficient income and savings to purchase a home. Instead, subprime lending is alive and well in the U.S. In fact, it is back with a vengeance; this time it is promoted, financed, guaranteed, and subsidized by none other than the U.S. Government. The government backstop provided by Ginnie Mae, in confluence with ever increasing loan volumes and the opening of the credit box, have allowed risky lending to return to the fore once again, putting both taxpayers and borrowers at risk. Ginnie Mae, whose goal is to promote home ownership and affordable housing, is now serving as the largest sub-prime mortgage guarantor in the world.

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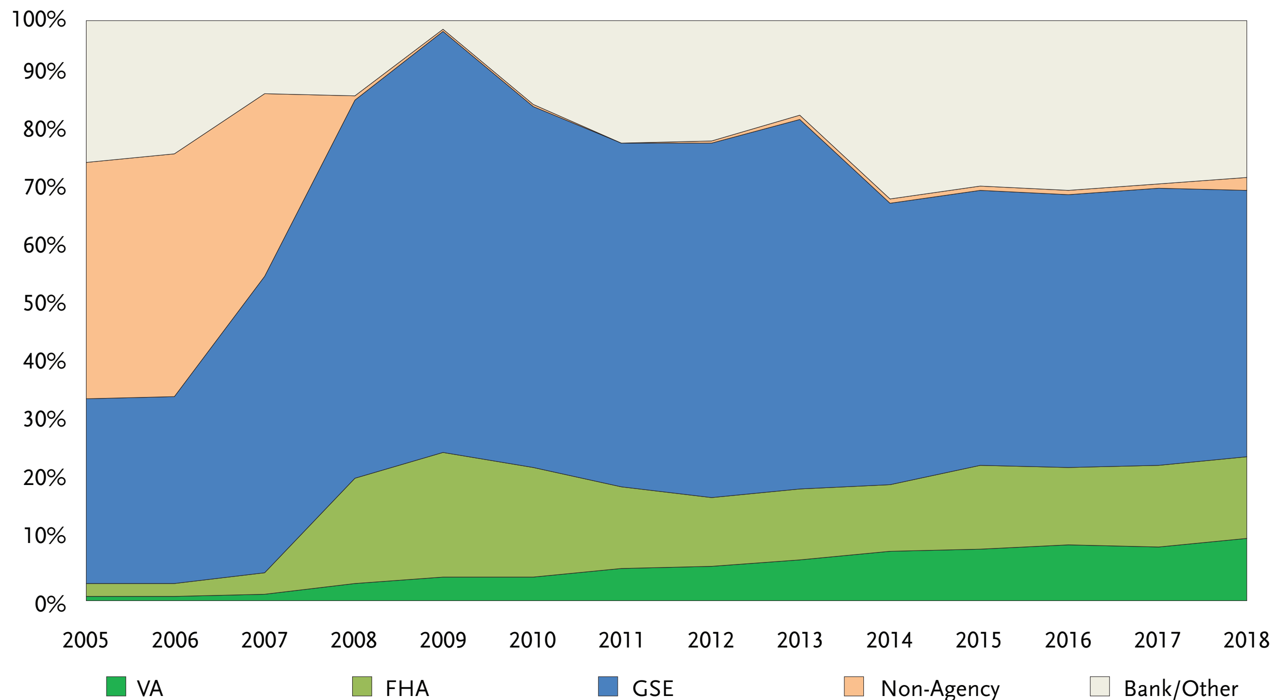
Figure 1: Home Mortgage Origination Volume Channel Distribution



Source: Morgan Stanley Research, IMF

Ginnie Mae acts as a securitization arm for mortgage loans that are already insured, in large part, by either the Federal Housing Administration (FHA) or the Veterans Administration (VA). Created in 1968 to increase availability of mortgages to consumers, Ginnie Mae is backed by the "full faith and credit" of the U.S. Government. Yet even the FHA and VA, which guarantee the loans placed into Ginnie Mae securities, are operated by the U.S. Government, replacing market incentives with rules and actions of government actors. This top-down government approach to mortgage lending has assisted in the reopening of the credit box, bringing back many aspects of the aggressive lending that characterized the pre-crisis era. However, this time, it is the government, not the investors, that will be on the hook if there are substantial loan losses. In practice of course, this means taxpayers will be holding the bag if challenges and eventual losses arise once more in home lending. Making matters worse, the potential losses are not small. These contingent liabilities are likely underappreciated by many government officials who may take comfort in the current low delinquency levels in home lending, remaining unconcerned about potential losses in the next housing or economic downturn.

Prior to the crisis, FHA/VA lending, which makes up the vast majority of loans securitized into Ginnie Mae MBS, was less than 5% of yearly originations. Today, Ginnie Mae guarantees 25% of all single-family mortgages originated between the FHA and VA programs (Figure 1). That adds up to over $2 trillion in outstanding mortgage loans that are now directly guaranteed for payment of timely interest and full principal to investors. Interestingly, in 2010 Ginnie Mae's outstanding principal balance was just $1 trillion (Figure 2, page 3). To further illustrate the point, Ginnie Mae now has four times more in home loans outstanding than prior to the GFC. Given Ginnie Mae's mandate, it receives an "A" for promoting home ownership and affordable housing finance. However, the vast majority of the loans Ginnie Mae guarantees today are either to borrowers with low credit scores or to homeowners making little or no down payment or having very little built up equity when they refinance. For these risky loans to work out for the taxpayers, housing prices cannot fall without default risks rising. Further complicating matters, the FHA recently reported a 2.76% capital ratio. While widely considered as a positive trend because it is above the congressionally mandated 2% threshold, the number still leaves Ginnie Mae with a debt to equity ratio of 36 to 1. No private lender could survive a full credit cycle with a capital reserve ratio that paltry. However, instead of working to mitigate and correct a potentially multi-billion dollar taxpayer liability, the investor is safeguarded by the security of a government guarantee, while taxpayers are left with long-dated risks and little protection to fall back on.

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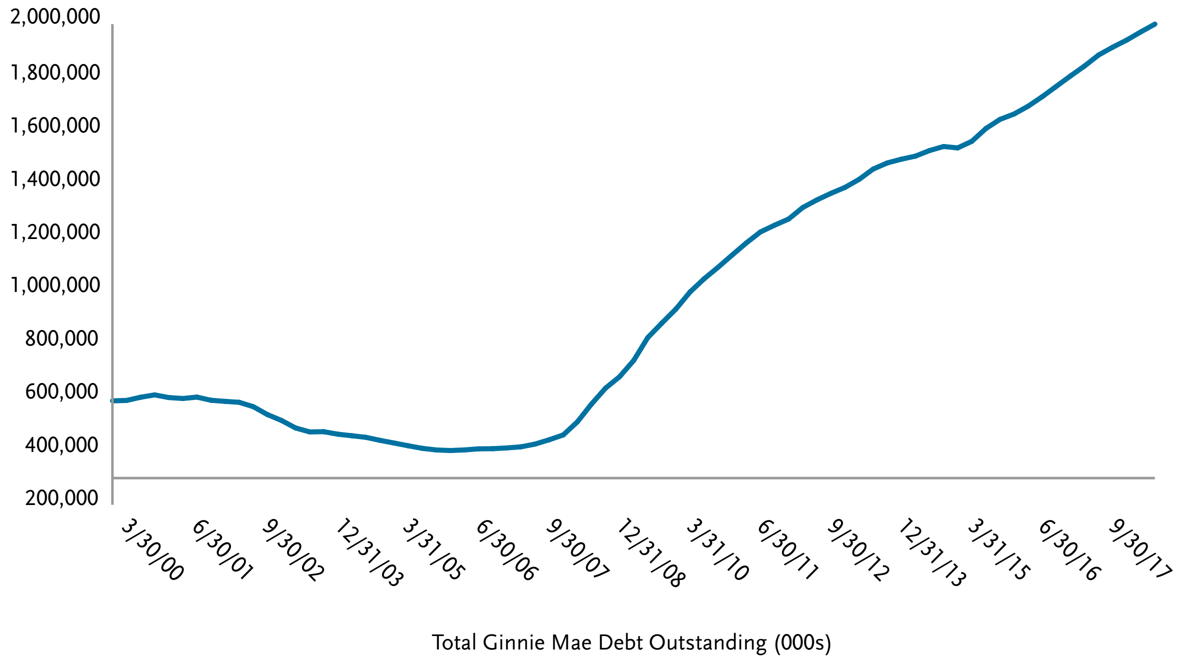
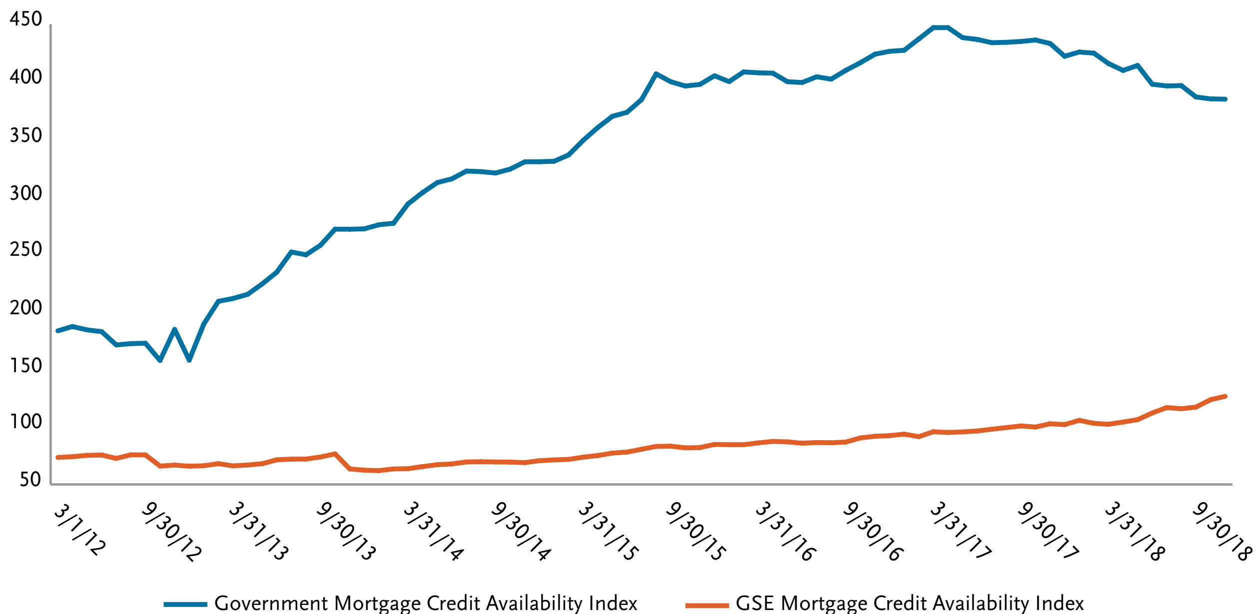
Figure 2: Total Ginnie Mae Debt Outstanding (000s)



Source: Bloomberg

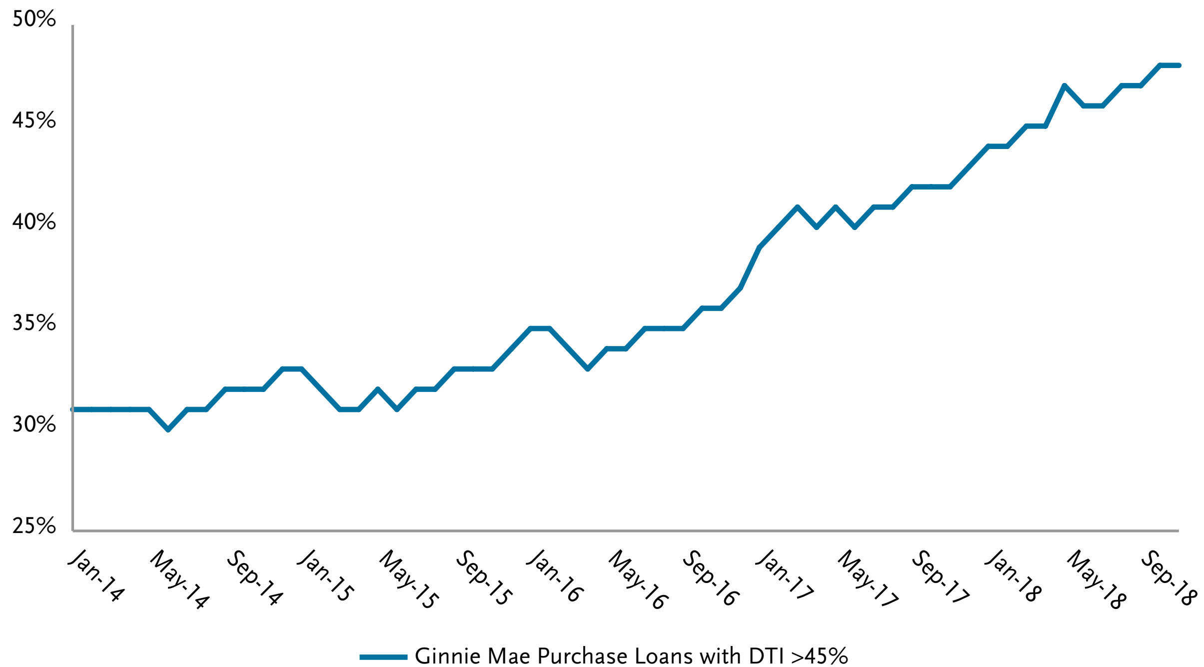
Unfortunately, potential challenges are not merely confined to the growth of Ginnie Mae loan guarantees. The credit profile of loan originations is eroding with the newest loans entailing more risk than at any time since the GFC. In fact, Since 2013 credit availability has grown exponentially faster in collateral securitized into Ginnie Mae securities than in conventional MBS (Figure 3). Furthermore, combining high debt-to-income (DTI) ratios often above 45%, small down payments typically under 10%, and low borrower credit scores averaging well under 700 creates a toxic elixir that could explode in the event of a housing downturn. Almost 50% of Ginnie Mae originated purchase loans have DTI ratios over 45%, up from just north of 30% of new loans as late as 2014 (Figure 4, page 4).The rising DTI ratios should worry regulators, especially given that the economy is likely in the later stages of the credit cycle.

Figure 3: Credit Availability of Ginnie Mae v. GSEs



Source: Bloomberg

Figure 4: Ginnie Mae Purchase Loans with DTI >45%



Source: Wells Fargo, CPR CDR Technologies

Furthermore, the added loan volume in FHA and VA lending over the past several years has been increasingly originated by non-bank lenders due to reduced participation by larger lenders. Large banks ended up taking a large portion of losses in subprime lending both during and in the aftermath of the GFC. The GSEs required many originators to take back many defaulted loans due to incorrect or inadequate underwriting processes. Additionally, banks were hit with damaging lawsuits for their underwriting practices and are fearful of such an outcome again. In their place came non-bank lenders, many of which have limited capital to weather a financial storm, potentially placing cash flow burdens on these smaller institutions as upfront payments for servicing advances are required on delinquent loans.

No one doubts the good-intentions of these government mortgage finance programs to help promote home ownership to the under-represented, and often under-serviced lower income population. And few citizens question the benefits of helping veterans and their families achieve the American Dream. But good intentions do not necessarily create good results. Furthermore, what makes market-based economies function well is ensuring risk goes hand in hand with reward. Instead, many lower income borrowers could be left in challenging financial situations during the next financial downturn. Borrowers in homes with negative equity are less able to pursue opportunities that require them to move, potentially reducing job mobility and limiting their long run opportunity set and upward economic progress. So it is not simply taxpayers who are at risk; some of the intended beneficiaries of the government's largesse could be harmed by the very hand that was supposed to help them.

Due to the significant growth in total volumes, and given the typical Ginnie Mae borrower's levered credit profile, the soft underbelly of the agency mortgage market continues to grow unabated, with no plan in place for what happens if housing or the economy gets into trouble. Today, there is little discussion of altering the credit profile of future borrowers with government guaranteed mortgages. Instead, policy makers appear fairly naïve about the consequences of their actions. The irony is that the government put much of the blame for indiscriminate subprime lending squarely on the backs of the banks. Billions in lawsuit settlements have been levied against the banks in the aftermath of the housing crisis. Yet this time the government is the primary one to blame for taking on levered borrower exposure as well as the potential for loan losses stemming from the FHA or VA lending programs. Moreover, the most likely government response will be to subsidize those borrowers further with mass loan modifications, with taxpayers once again shouldering the load for markets and government mismanagement. Moving past a cycle of government overreach and constant taxpayer support of the mortgage finance market should be a higher priority moving forward.

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The best time to confront the challenges of Ginnie Mae's increasing and problematic role in the mortgage market is before another crisis or downturn occurs. Unfortunately, a divided Congress is currently far more interested in offering platitudes than engaging in the difficult debate over potential policy options. The market therefore can have little confidence that Congress will act in a responsible, bipartisan way before the next elections in 2020. Until then, regulators and agency heads will need to work on non-legislative reform measures to reduce risks to taxpayers and low income borrowers alike. While Fannie Mae and Freddie Mac implemented a credit risk transfer market in 2013 to help off-load their mortgage credit exposure to the private market, little progress has been made on reigning in the credit risk building within the government guaranteed loan market. Americans should all ***hope*** that the housing market remains vibrant and buoyant until Congress can come together and pass risk-reducing bipartisan legislation. But then again, ***hope*** is a horrible hedge. ■

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