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Serving Mortgage Market Segments Effectively

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Lowering the cost of capital required by government-sponsored enterprises can safely and efficiently serve higher-risk segments of the market, increasing opportunity for homeownership and improving market stability.

Government-sponsored housing finance agencies can serve a purpose and public benefit distinct from yet complementary to the pure private market by serving creditworthy borrowers considered too risky for the private market to serve profitably.

Doing so will require allowing these agencies to price their mortgages in such a way that risk is covered but mortgages remain affordable. This can be accomplished by allowing the agencies to employ a model that lowers their return on capital and spreads risk across their portfolio.

Risk-based Pricing in the Private Sector

If government-sponsored mortgage lending did not exist, private mortgage lenders most likely would employ risk-based pricing of home loans. In this model, the price of credit rises along with credit risk, as Chart 1 shows. The price of credit (red solid line) reflects the market return on capital (red dash line) and a premium precisely tailored to the estimated level of risk at every point in the distribution of households (i.e., risk-based pricing).

The risk tolerance of the private market varies, depending on the recent performance of its loans, which leads to volatility in credit availability and house prices. In addition, a large segment of creditworthy borrowers are denied mortgage credit, depriving them of a proven method of building wealth.

Average Risk Pricing in the Government-Supported Market

Government-supported housing finance agencies, by contrast, can expand the opportunity for homeownership to a broader segment of society by adopting a model that incorporates two key components: risk pooling (or average-risk pricing) and a lower return on capital.

Average-risk pricing enables these agencies to spread the risk of loans across the entire portfolio, which reduces the cost of credit for individuals, regions or time periods perceived as higher risk.

If the government-sponsored enterprises adopted risk pooling while still requiring a market return on capital, the resulting guarantee fee (shown as a light blue line in Chart 2) would substantially overcharge lower-risk borrowers. These borrowers would then be steered toward the lower prices available in the private sector. The borrowers remaining in the Enterprises' portfolio would be disproportionately higher risk as – a problem known as adverse selection – and the Enterprises would be forced to raise their guarantee fees.

However, the Enterprises do not need the same return on capital as the private market because their government sponsorship lowers their costs. Further, Fannie Mae's charter explicitly states that activities relating to mortgages for lower income families may involve "a reasonable economic return that may be less than the return earned on other activities" (12 USC § 1716). The blue dashed line in Chart 2 shows the lower level of return that is sufficient to cover their risk and costs.

Adopting a model that combines both average-risk pricing along with a lower cost of capital can create an efficient segmentation of the mortgage market. The decrease in the cost of capital lowers the total price of credit so that some lower-risk borrowers find it advantageous to stay in the Enterprises' portfolios. The Enterprises can then use these borrowers to offset the credit risk of higher-risk borrowers, but both groups benefit from a more stable and affordable housing market.

Conclusion

The private market remains an efficient source for serving the highest-quality credit borrowers and robust housing markets. However, an additional segment of creditworthy borrowers can

be served by government-sponsored enterprises, expanding the opportunity and benefits of homeownership more broadly and supporting a more robust housing market.

Chart 1. Model of Risk-Based Pricing in the Absence of Government-Supported Entities

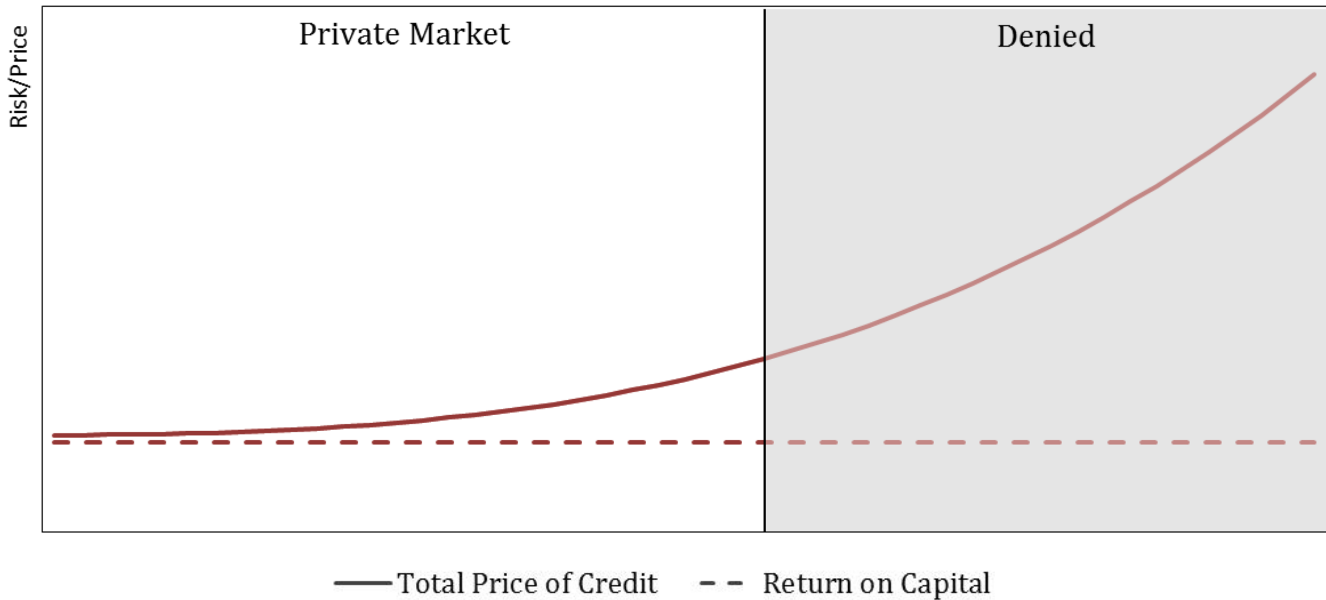
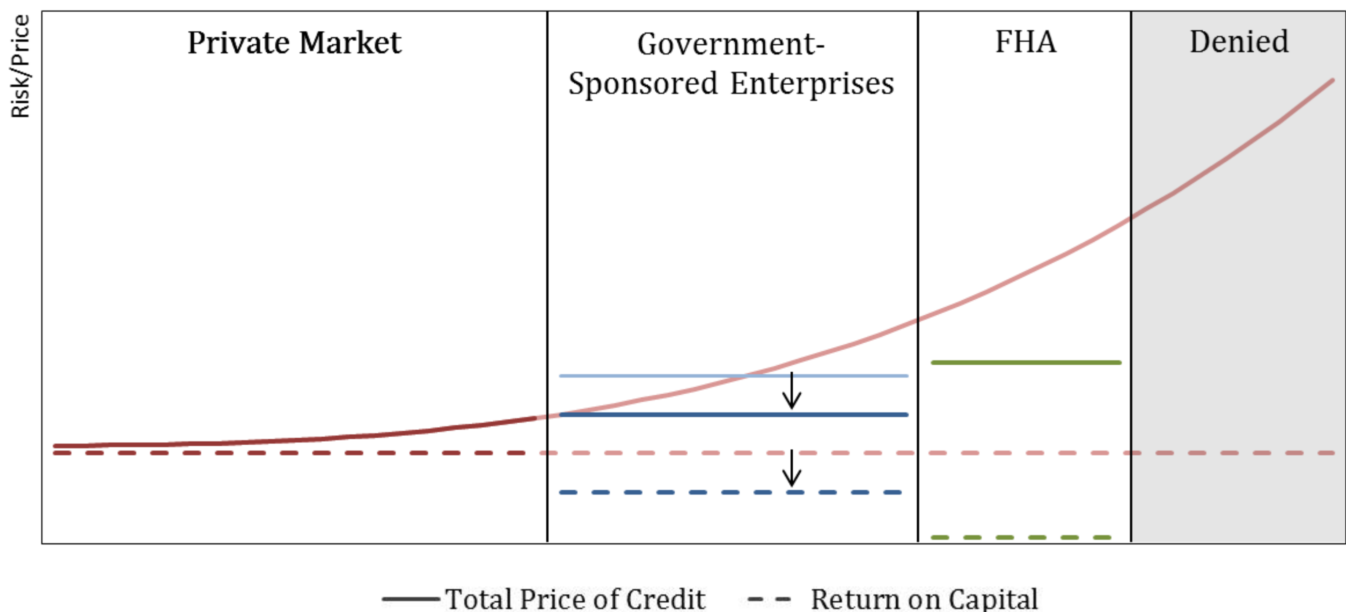


Chart 2. Model of Market Segmentation with Purpose-Based Return on Capital



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