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Government Intervention in Mortgage Finance: The Case Against 'AussieMac'

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The sub-prime mortgage crisis in the United States that began in August 2007 has had far-reaching consequences for global capital markets. For a small and open economy like Australia's, the price of capital is largely determined in these global markets, so wholesale funding costs for Australian financial intermediaries have increased as a result of the crisis. Both bank and nonbank lenders have raised their retail lending rates, reflecting this higher cost of funds. Nonbank lenders have been hit particularly hard, as they rely more heavily on capital markets for funding, whereas the larger banks can also access funding from their retail deposit base.

Prior to the onset of the credit crisis, nonbank lenders were able to obtain wholesale funding through the market for residential mortgage-backed securities (RMBS). The credit crisis has seen a sharp reduction in the issuance of RMBS, reflecting reduced investor appetite for these instruments and making it difficult for nonbank lenders to originate new mortgage finance at competitive rates. There has been a reduction in mortgage lending by nonbank financial institutions, and a loss of market share to the major banks.[1]

These developments have raised concerns about an apparent reduction in competition in retail mortgage lending. While the credit crisis is temporary, it may take some years before the market for RMBS fully recovers. This has led to proposals for government intervention in these markets. In particular, it has been suggested that the federal government should sponsor an institution, dubbed AussieMac, to acquire RMBS to promote the continued functioning of these markets. The acquisition of these securities would be funded by issuing government bonds, taking advantage of the government's ability to access capital markets on more favourable terms. These proposals are explicitly modelled on similar government-sponsored enterprises (GSEs) in the United States, known as Freddie Mac and Fannie Mae.

This paper argues that the AussieMac proposal is unlikely to deliver significant benefits for Australian homebuyers, and that government intervention in the market for mortgage-backed securities is an inefficient way of promoting housing affordability. Australia cannot insulate itself from developments in global capital markets, which convey important price signals to lenders and borrowers. The international and cyclical influences on Australian mortgage interest rates are very large relative to the contribution from lending margins. Narrower lending margins may be fully offset by the monetary policy actions of the Reserve Bank of Australia (RBA) in maintaining its desired level of credit restrictiveness. To the extent that lower mortgage interest rates could be realised, this would be capitalised into house prices, with adverse implications for housing affordability.

The proposed institution would amount to an indirect government subsidy to the mortgage securitisation industry, which could ultimately damage competition in the provision of housing finance. Experience with comparable institutions in the US and Canada suggests that little of this subsidy is passed on to home borrowers. Lower wholesale funding costs could only be achieved by exploiting implicit or explicit government guarantees and the government's power to tax. Overseas experience

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shows that there are significant risks associated with government-sponsored housing finance enterprises even when they are in private ownership. As a government-sponsored institution, taxpayers would be exposed to any losses on the proposed institution's portfolio. The two housing GSEs in the US, Freddie Mac and Fannie Mae, have exerted a destabilising rather than a stabilising influence on US housing finance, financial markets, and fiscal policy.

The 'AussieMac' proposal

The main proposal for government intervention in the market for housing finance comes from Christopher Joye and Joshua Gans.[2] They have called for the establishment of a government-sponsored institution to provide long-term liquidity in the domestic market for mortgage-backed securities. They have dubbed the institution 'AussieMac,' since their proposal is explicitly modelled on Freddie Mac, an institution that performs a similar function in the US. Invoking the US model, Joye and Gans propose that

> the Commonwealth Government could guarantee the credit worthiness of a similar Australian government agency, referred to here as 'AussieMac,' thereby lending it Australia's AAA credit rating. This would allow AussieMac to issue substantial volumes of extremely low cost bonds into the domestic and international capital markets. The funds raised through issuing these bonds could be used to acquire high-quality AAA-rated Australian home loans off the balance-sheets of lenders. AussieMac would therefore serve to guarantee liquidity in the Australian home loan market in the event that other private sources of capital were to supply insufficient funding, such as is currently the case … In the near- to medium-term AussieMac could be privatised with the result that its debt would be taken off the government's own balance sheet, if that was deemed desirable.[3]

Government intervention in the market for mortgage-backed securities is an inefficient way of promoting housing affordability.

The aim would be to 'insulate Australian households, and the key financial institutions that provide them with funding, from external capital market shocks that have nothing to do with the integrity of the Australian economy, its financial system or the quality of Australian home loans.'[4] They suggest that such an institution would promote the 'public goods' of liquidity and price discovery. While the characterisation of liquidity as a public good is questionable, it is not essential to their case for government intervention. Joye and Gans also question the efficiency and rationality of financial markets, claiming that recent developments in global capital markets are 'a classic case of market failure and with that a presumptive rationale for government intervention.'[5] While questionable, these claims are also not essential to their proposal and so will not be pursued here. However, it should be noted that there is no reason to believe that a government-sponsored entity would be better able to evaluate and price credit risk in the relevant markets than existing participants.

Joye and Gans's main concern is with promoting competition in Australian mortgage lending, arguing that the recent credit crisis threatens to 'undermine a decade or more of microeconomic achievement.'[6] They point to experience with these institutions in the US, claiming that 'Fannie Mae and Freddie Mac have been extraordinarily successful institutions for the best part of 50 years,'[7] and arguing that 'the Australian mortgage market is suffering from the absence of equivalent support.'[8] They cite evidence to suggest that these institutions have resulted in lower mortgage interest rates, with estimates ranging from twenty-five to fifty basis points. They fail to mention studies that point to an effect of as little as seven basis points, with the bulk of the implicit government subsidy accruing to GSE shareholders rather than home borrowers.[9] There is also little evidence of an increase in homeownership or home-building associated with the US GSEs.[10] In US Congressional testimony, then Federal Reserve chairman Alan Greenspan described the ultimate benefits for borrowers (as opposed to GSE shareholders) as being 'between de minimis and small.'[11] Greenspan also warned that the two US GSEs posed systemic risks to the US financial system, noting in his memoir that they had 'begun to distort and endanger the markets and seemed likely to become a bigger and bigger problem.'[12] As we shall see, these warnings now look prophetic.

Similar proposals have been made in the UK and were considered by the UK Treasury's review of mortgage finance headed by James Crosby. But in remitting his interim analysis to the Chancellor of the Exchequer, Crosby said of these proposals, 'I think it unlikely that it would be right to tackle this century's problems with last century's solution.'[13]

The AussieMac proposal has received support from many involved in the nonbank home mortgage industry, including the peak industry body, the Australian Securitisation Forum. [14] This is not surprising, since the proposal would benefit participants in the mortgage securitisation industry. The proposal has attracted interest from the Senate Select Committee on Housing Affordability, which supported a Treasury examination of AussieMac as part of its recommendations. It has also featured in submissions to the House of Representatives Standing Committee on Economics Inquiry into Competition in the Banking and Non-banking Sectors. There is a risk that Australian politicians will be lured by the promise of lower home-loan interest rates to support the creation of a US-style government-sponsored housing finance institution in Australia.

The AussieMac proposal would not insulate Australia from developments in global capital markets.

Global capital markets and Australian housing finance

The AussieMac proposals aim to insulate Australian borrowers from developments in international capital markets. This is an unrealistic objective, because Australia is highly dependent on these markets to fund domestic consumption and investment spending in excess of domestic saving, or equivalently, the current account deficit. As a small economy with an open capital account, Australia is necessarily a price-taker rather than a price-maker in international capital markets. Only the US economy is large enough to exert a major influence on the global price of capital. This explains why Australian banks and nonbank financial institutions alike have had to raise mortgage interest rates over and above changes in the official cash rate set by the Reserve Bank in the wake of the sub-prime mortgage crisis. There is no necessary relationship between market-determined mortgage interest rates and the Reserve Bank's official cash rate, since the official cash rate is only one, albeit important, component of the overall cost of funds faced by Australian financial institutions.

The AussieMac proposal would not insulate Australia from developments in global capital markets. Instead, it seeks to exploit the government's ability to access capital markets on superior terms to supply mortgage finance at a lower cost than might otherwise be possible given prevailing market conditions. This would not change the basic fact that Australian borrowers must compete with the rest of the world for access to capital, and global interest rates would still be a dominant influence on domestic interest rates. It would simply substitute a government-sponsored intermediary into the funding process that underpins housing finance. The yields on the government bonds that AussieMac would rely on for funding are not immune to these international influences and are still subject to sovereign risk premiums. Since Australia is competing with the rest of the world for access to available capital, the price signals communicated by interest rates in global capital markets are still highly relevant to Australian borrowers and lenders.

Competition in financial intermediation and housing finance

The AussieMac proposal wrongly characterises the domestic implications of the recent global credit crisis as giving rise to a failure of competition, and blames this on the absence from Australia of government-sponsored housing finance institutions such as those present in the US and Canada. The recent problems in global credit markets and the market for mortgage-backed securities are more accurately characterised as a temporary negative shock to available financial technology and market liquidity. RBA assistant governor Philip Lowe has said that 'these changes in the competitive position of different lenders are probably best thought of as cyclical, rather than structural … when conditions improve, as they inevitably will, these lenders will find that their competitive position also improves.'[15] The real issue is whether government can supply a superior substitute technology, on either a temporary or permanent basis, that will result in long-term improvements in financial intermediation, with benefits for home borrowers (as opposed to financial intermediaries) and without significant risks to taxpayers.

It is not surprising that large, well-capitalised banks are better able to withstand temporary liquidity shocks than the smaller nonbank lenders. While the globalisation of banking has facilitated the international propagation of financial shocks, large global financial institutions are also able to draw on internal sources of funding and are thus better equipped to withstand these shocks. Nicola Cetorelli and Linda Golberg note that 'a banking system that grows increasingly global may have enhanced resilience and self-adjustment in times of liquidity crisis.'[16] In the US, questions have been raised about whether Freddie and Fannie add to liquidity in a time of crisis, or only when it is profitable to do so, thereby contributing volatility rather than stability to the market.[17]

The AussieMac proposal would establish a lengthy chain of financial intermediation, from the market for Australian sovereign debt instruments, through the government-sponsored entity and the mortgage securitisers, to home borrowers, at little apparent cost to the federal budget. But the proposal still entails giving AussieMac and the mortgage securitisers access to a valuable resource: the government's sovereign credit rating and its power to tax. It is only by exploiting this resource that the GSE could access capital markets on better terms than other intermediaries. As Feldman notes, there is an opportunity cost to taxpayers in exploiting this resource. It represents a benefit for which those competing with the GSE or the mortgage securitisation industry would be willing to pay.[18]

A GSE could 'crowd out, and thus further harm, the industry it was intended to support.'

There is a potential conflict of interest between maximising returns to taxpayers or shareholders in the proposed GSE and passing on the benefits of lower funding costs to borrowers.[19] The nonbank lenders would be similarly conflicted. US experience suggests that a lower cost of funds could be appropriated either by management of the GSE in the form of higher costs, or by shareholders in the form of higher profits. The mortgage securitisation industry might also be expected to capture some of these benefits at the expense of home borrowers. The Reserve Bank has shown that the government subsidy provided by the Canadian housing GSEs 'was retained by the smaller financial institutions, rather than passed on to households' during the recent credit crisis.[20]

AussieMac could be successful only by using its government-supplied competitive advantage to disintermediate competing institutions. Joye and Gans are conscious of this risk, but argue that 'you could limit AussieMac to supplying no more than say, 5%–10% of the market liquidity.'[21] Yet if AussieMac were thought to confer real benefits for home borrowers, it would be hard to make a case for imposing or respecting such limits. Taken to its logical extreme, one could make a case for the complete disintermediation of all private-sector wholesale funding, substituting cheaper government debt financing. This argument could even be generalised to borrowing for purposes other than housing, notwithstanding the fact that the government's growing exposure to mortgage and other lending could ultimately jeopardise its ability to access capital markets on more favourable terms.

Affording a competitive advantage to one class of intermediaries is not necessarily a desirable way to promote long-run competition in mortgage finance. The Australia-New Zealand Shadow Financial Regulatory Committee has noted that a GSE could 'crowd out, and thus further harm, the industry it was intended to support.'[22] Purchasing mortgage-backed securities directly from their originators may reduce the incentive to develop markets for these assets.[23] In the United States, the competitive advantages bestowed upon Freddie Mac and Fannie Mae by the US government now see them account for around half of all outstanding mortgage debt in the US, in the amount of some five trillion US dollars. Freddie and Fannie grew faster than the mortgage market itself, to the extent that they began to run out of qualifying mortgages to hold or securitise. This in turn promoted mission creep, whereby Freddie and Fannie sought to expand their role into a broader range of assets and markets, including sub-prime lending.[24] As Peter Wallison, Thomas Stanton, and Bert Ely note, their government backing 'has given them an unassailable oligopsony … and dominance of the residential real estate finance market … such markets are characterised by limited competition, higher prices and a lack of innovation.'[25] The growth in the US mortgage securitisation market arguably owes more to regulation and arbitrage of regulatory capital requirements by US financial institutions than any efficiency gains associated with the GSEs.[26] Wallison, Stanton, and Ely conclude that the full privatisation of Freddie and Fannie offers the 'prospect of a more-efficient, lower-cost system for financing home mortgages.'[27]

Mortgage interest rates and monetary policy

Just as international influences on domestic interest rates are large relative to the influence of lending margins, so too is the influence of domestic monetary policy. Since the credit crisis began in August 2007, the RBA has allowed market-led increases in retail lending rates to substitute for increases in the official cash rate in achieving its desired level of credit restrictiveness. However, this relationship between RBA policy actions and retail lending rates is a symmetrical one. As recently as August 2006, the RBA rationalised an increase in the official cash rate on the basis that retail lending margins over the official cash rate had contracted, reflecting increased competition from nonbank lenders. In announcing a tightening in monetary policy on 2 August 2006, RBA governor Ian Macfarlane said that 'compression of lending margins over recent years has contributed to a lowering of borrowing costs relative to the cash rate. This has meant that although the cash rate has recently been slightly above its average for the low-inflation period since 1993, interest rates paid by borrowers have remained below average.'[28] It is possible that any benefits from the creation of AussieMac could be fully offset by the RBA in seeking to maintain a given stance for monetary policy. These two arms of government would operate at cross purposes, with no benefit in promoting cheaper housing finance.

It is possible that any benefits from the creation of AussieMac could be fully offset by the RBA in seeking to maintain a given stance for monetary policy.

Joye and Gans suggest that AussieMac would 'assist in the development of 30-year and 40-year fixed-rate home loans in Australia, which are such a critical element of the US market but unseen here.'[29] Adjustable-rate mortgages are far less common in the US, because federal regulations have prevented depository institutions from originating them.[30] Given the recent problems in US housing, it would seem undesirable to import some of the structural characteristics of the US mortgage market into Australia. The interest rate and prepayment risks associated with fixed-rate mortgages mean that even highly creditworthy borrowers can present substantial risks to the holders of mortgage debt. Even when the probability of default is low, the cash flows associated with these instruments may be highly uncertain, and it can be difficult to match the duration of assets and liabilities without using complex hedging instruments that are themselves risky.[31]

The predominance of longer-term, fixed-rate mortgages in the US is a structural problem from the standpoint of US monetary policy. It weakens the transmission of changes in the US official interest rate, the Fed funds rate, to retail mortgage interest rates, making monetary policy less effective in managing aggregate demand. This helps explain why the official interest rate cycle has been much more pronounced in the US than in Australia in recent years. Variable-rate mortgage debt instruments may increase the effectiveness of monetary policy and enhance the Reserve Bank's capacity to manage demand.

The Reserve Bank of Australia has taken a flexible approach to the conduct of open market operations in support of financial system liquidity, and has expanded the scope of these operations in response to the credit crisis.[32] Joye and Gans argue that these operations discriminate against nonbank lenders.[33] From the RBA's perspective, eligibility requirements are 'limited to operational issues related to the effective implementation of monetary policy.'[34] The RBA takes a cautious approach to its own capital position, and is appropriately wary of engaging in transactions where the counterparty is also the originator of the assets involved. But there are no significant obstacles to the RBA further expanding the scope of its open market operations to reduce liquidity premiums in a wide range of markets, if this is deemed necessary. These operations could even be expanded to include outright purchases of the relevant assets, although that could have implications for the stance of monetary policy and inflation. Since the balance sheet of the central bank is denominated in its own monetary liabilities, which are ultimately irredeemable, central banks do not face the same solvency constraints as private institutions. The RBA thus already provides a very robust infrastructure for supporting liquidity in relation to a broad range of instruments and counterparties in times of market stress.

Lower lending margins would likely be capitalised into house prices, offsetting any benefit to housing affordability.

Promoting housing affordability

The AussieMac proposal only has value for homebuyers if it improves housing affordability. If there are no benefits for consumers, there is no reason to support government intervention in housing finance. Lending margins are a factor in housing affordability, together with the overall level of interest rates, house prices, and disposable income. Lower interest rates increase housing affordability for a given level of house prices, but there is feedback between asset prices and interest rates. As a generalisation, lower interest rates are associated with higher asset prices, including house prices, although asset prices depend on a broader range of factors apart from interest rates. Recent experience in Australia and the US suggests that low interest rates may have been a factor in promoting house-price booms, just as higher interest rates in Australia have weighed on house prices more recently. Lower lending margins would likely be capitalised into house prices, offsetting any benefit to housing affordability. This would benefit existing homeowners, but at the expense of new homebuyers.

Adding to the amount that can be spent on housing would increase demand for a given level of housing stock, increasing house prices and reducing housing affordability. The issue of housing affordability needs to be tackled from the supply side, not the demand side. The AussieMac proposal, even if successful in lowering interest rates, would join a long list of failed efforts to improve housing affordability that have increased demand for housing without augmenting supply.

GSEs are an inefficient way for governments to direct benefits to homebuyers, with policymakers having at best indirect control over the size or the transmission of the subsidy to retail borrowers.[35] The wide range of estimates in relation to the benefits of GSEs to US home borrowers highlights the lack of transparency surrounding the size and nature of the benefit, making it difficult to monitor the extent of pass-through to consumers.

Freddie, Fannie, and the road to financial Armageddon

AussieMac is explicitly modelled on Freddie Mac and Fannie Mae in the US. It is therefore instructive to consider the US experience and its possible lessons for Australia. Joye and Gans suggest that the US experience with these government-sponsored enterprises has been an almost unqualified success, ignoring the serious problems these entities have created for the US housing market and the risks they have posed to US financial markets and taxpayers.

Fannie Mae has its origins in the Depression-era *National Housing Act*, which, among other things, mandated the creation of the Federal National Mortgage Association (FNMA), later dubbed 'Fannie Mae' by market participants. It was privatised in 1968, mainly as a fiscal window-dressing exercise that shifted its debts off the federal government's balance sheet. Freddie Mac was mandated by Congress in 1970 to support the savings and loan (S&L) industry by securitising its mortgages, and became a publicly listed company in 1989 as part of measures to support what was then an ailing S&L industry.

Freddie and Fannie have come to occupy a dominant position in the US mortgage market on the back of their Congressional mandates and preferential statutory exemptions.

Freddie and Fannie have been described as 'among the most politically powerful entities in Washington.'[36] They have been aggressive defenders of their privileged position in the marketplace, enjoying the political protection of Congress, which saw the two GSEs as a way of subsiding home lending off the balance sheet of the US government with no apparent cost to US taxpayers. Government protection has seen problems with corporate governance, accounting fraud, and political corruption become a pervasive feature of the two GSEs. In 2004, the chief accountant of the Securities and Exchange Commission found that Fannie Mae had violated accounting rules, ordering it to restate earnings to include US$9 billion in losses.[37] In 2006, Freddie Mac reached a settlement with the Federal Election Commission in relation to illegal political fundraising activities on behalf of politicians of both major parties.[38] The *Wall Street Journal* has accused the GSEs of 'using government-guaranteed profits to lobby for continued government protection. Congress sets the rules in favor of Fan and Fred, which then repay the Members with cash from their rigged profit stream. This is the government lobbying itself for more government.'[39]

While the US government had always denied that it was a guarantor of Freddie and Fannie's debts, this denial increasingly lacked credibility as the two GSEs came to dominate the mortgage market, becoming 'too big to fail.' Since Freddie and Fannie were the only significant buyers of mortgage-backed securities in the wake of the credit crisis, they could not be allowed to fail without further destabilising financial markets. The 'stabilising' role these institutions are meant to play has thus been achieved only by exposing US taxpayers to significant risks. Their debt instruments have long been seen as safe as US government Treasuries, meaning that investors were willing to supply funds at yields that were inconsistent with the risks these institutions were assuming in financial markets. Freddie and Fannie can borrow at interest rates typically only available to AAA-rated corporates. In the absence of implicit government guarantees, their ratings would be AA or lower.[40] This afforded funding advantages estimated as ranging from thirty to forty basis points, although as noted earlier, this advantage has not been fully passed through to borrowers. Freddie and Fannie's debt instruments are widely held throughout the world's financial institutions, which often face lower capital requirements in relation to Freddie and Fannie's securities, encouraging substitution out of other types of mortgage lending. If the implied US government guarantee were thrown into serious doubt, the valuation of these securities would also be called into question, threatening the capitalisation of financial institutions all over the world. Freddie and Fannie present risks not only to the US taxpayer and financial markets, but also to the entire international financial system.

Freddie and Fannie present risks ... to the entire international financial system.

Like the AussieMac proposal, the position of Freddie and Fannie in the US mortgage market was rationalised as being a force for stability in US home lending and financial markets. In the early stages of the credit crisis in 2007, Freddie and Fannie were mandated an even larger role, with the Bush administration reducing their capital requirements and raising their portfolio caps while Congress increased the size of the loans they could purchase or guarantee. They soon accounted for some 70% of new mortgages.[41] Freddie and Fannie were expected to perform their statutory function of helping to stabilise the market for US mortgage finance.

Freddie and Fannie's privileged position in the marketplace meant that they faced little effective market discipline, and were highly leveraged compared to banks and other financial institutions of equivalent size, operating from a very small capital base.[42] By the end of March 2008, the combined capital of the two GSEs stood at US$81 billion, only 1.5% of the outstanding mortgage debt on their books. This left them extremely vulnerable to small changes in the value of their assets arising from the sub-prime mortgage crisis. As the crisis unfolded, Freddie and Fannie initially sought to conceal the adverse implications for their capital position.[43] For the nine-month period ending with March 2008, the two GSEs reported losses of US$11 billion,[44] leaving Freddie Mac technically insolvent and Fannie Mae enjoying only a small positive net worth.[45] Fannie Mae also faced near-insolvency in the early 1980s.[46]

Things came to a head in July 2008, when equity markets started to question whether Freddie and Fannie were adequately capitalised, sending the share prices of the two GSEs crashing. To reassure markets that Freddie and Fannie were not about to fail, which would have had potentially devastating consequences for US and global financial markets, the US Treasury extended additional lines of credit to the two GSEs and sought authorisation to purchase their stock. The implicit government guarantee to the two GSEs had become explicit.

In 2005, Frame and White estimated the contingent liability of Freddie and Fannie to the US government at US$288 billion,[47] although this estimate would have ballooned since then. The US Congressional Budget Office has estimated that the US Treasury's line of credit and possible equity purchases in Freddie Mac and Fannie could potentially cost US taxpayers US$25 billion, noting that there was a small chance the two GSEs could post further losses of more than US$100 billion.[48] In the extreme case, of nationalisation, Freddie and Fannie's US$5 trillion in liabilities would be added to the public debt of the United States, putting at risk the US government's sovereign credit rating and US dollar denominated asset prices. Ratings agency Standard & Poor's said in April 2008 that Freddie and Fannie were the biggest threat to the US government's credit rating.[49] This eventuality would undermine the funding advantages enjoyed not only by Freddie and Fannie, but by the entire US government and all issuers of US dollar denominated debt. Instead of playing a stabilising role in US financial markets, Freddie and Fannie became a source of systemic risk, as for many years Alan Greenspan and others had warned they might.

Taxpayers should not be surprised when they are told they have to pay the cleanup bill for the financial risks they underwrite through GSEs.

An Australian GSE need not necessarily fall victim to the problems experienced by Freddie and Fannie in the US, and would not have the same capacity to destabilise global financial markets. But the same political and economic considerations that gave rise to the problems in the US could be expected to operate in Australia. Alan Greenspan noted in the US context that 'world-class regulation, by itself, may not be sufficient and … may even worsen the situation if the market participants infer from such regulation that the government is all the more likely to back GSE debt.'[50] The long history of Australian politicians' populist bank-bashing suggests that once AussieMac was established they would have every incentive to expand and empower it at the expense of other financial intermediaries, in the name of promoting housing affordability. Once government had become invested in such an enterprise, it would become difficult for it to admit to failure.

The apparent lack of a direct or immediate cost to the budget would also enhance the appeal of AussieMac to Australian politicians, although the exposure of taxpayers to the GSE's balance sheet would be a serious concern. The federal government is already exposed to the balance sheets of Australian banks through the provision of term funding by the Future Fund.[51] The federal government is thus implicated in providing capital to Australian banks at taxpayers' expense. While this term funding from the Future Fund is relatively low-risk, US experience suggests that these risks can easily multiply if there is unchecked growth in the exposures of GSEs to the lending portfolios of financial intermediaries. The US experience with Freddie and Fannie demonstrates that there is no free lunch in exploiting the government's power to tax to secure funding advantages in financial markets. Taxpayers should not be surprised when they are told they have to pay the cleanup bill for the financial risks they underwrite through GSEs.

Conclusion

Australian home borrowers have directly felt the dislocations in global credit markets that have occurred since August 2007. Given Australia's integration with global capital markets, it is neither feasible nor desirable to insulate Australian borrowers or lenders from price signals in these markets. The proposal for a government-sponsored enterprise to create a temporary or permanent market for mortgage-backed securities is unlikely, if implemented, to offer significant benefits to home borrowers or to improve housing affordability. Yet it would pose significant risks to taxpayers.

The influence of global capital markets and domestic monetary policy on mortgage interest rates could be expected to swamp the benefits from any reduction in wholesale funding costs even if these were passed on to retail borrowers. The US experience suggests that any benefits from exploiting the government's ability to access capital markets on superior terms would be captured by the GSE or the mortgage securitisers, at the expense of retail borrowers. An Australian GSE and the mortgage securitisation industry would likely expand only at the expense of other financial intermediaries, damaging long-run competition and innovation in the industry. At the same time, it would expose Australian taxpayers to the lending portfolios of nonbank financial institutions, with potentially destabilising consequences for the Commonwealth government's fiscal position if implicit or explicit government guarantees were called upon.

Endnotes

[1] See RBA Assistant Governor Guy Debelle, 'Recent Debt Market Developments' (address to the Debt Markets 2008 Summit, Sydney, 28 July 2008).

[2] Christopher Joye and Joshua Gans, *'AussieMac': A Policy Initiative for the Australian Government to Protect Households and the Financial System Against Current and Future Credit Crises*, Centre for Ideas and the Economy (Melbourne: Melbourne Business School, 2008).

[3] As above, 2.

[4] As above, 1.

[5] As above, 11.

[6] As above, 2.

[7] As above, 3.

[8] As above.

[9] The literature on this question is summarised in appendix 2 of Peter Wallison, Thomas Stanton, and Bert Ely, *Privatising Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: Why and How* (Washington, DC: AEI Press, 2004), 102–105. See also Wayne Passmore, Shane Sherlund, and Gillian Burgess, 'The Effect of Housing Government-sponsored Enterprises on Mortgage Rates,' *Real Estate Economics* (Fall 2005), 427–463.

[10] Wayne Passmore, *The GSE Implicit Subsidy and Value of Government Ambiguity*, Finance and Economics Discussion Series 2003-64 (Washington, DC: Federal Reserve Board, 2003).

[11] 'Fannie's Friends on the Hill,' *Wall Street Journal* (9 May 2005).

[12] Alan Greenspan, *The Age of Turbulence* (New York: Penguin Press, 2007), 242.

[13] *Mortgage Finance: Interim Analysis* (London: HM Treasury, 2008).

[14] The reaction to Joye and Gans is summarised in their *AussieMac: Postscript*, Centre for Ideas and the Economy (Melbourne: Melbourne Business School, 2008).

[15] Philip Lowe, 'The Financial Cycle and Recent Developments in the Financial System' (speech to the 6th Annual Retail Financial Services Forum, Sydney, 13 August 2008).

[16] Nicola Cetorelli and Linda Goldberg, *Banking Globalisation, Monetary Transmission, and the Lending Channel*, Staff Report 333 (New York: Federal Reserve Bank of New York, 2008).

[17] Peter Wallison, Thomas Stanton, and Bert Ely, *Privatising Fannie Mae, Freddie Mac, and the Federal Home Loan Banks*, 18.

[18] Ron Feldman, 'Uncertainty in Federal Intervention: Fannie Mae, Freddie Mac and the Housing Subsidy Trail,' *The Region* (September 1996), 1.

[19] Ron Feldman, 'Uncertainty in Federal Intervention.'

[20] Submission to the Inquiry into Competition in the Banking and Nonbanking Sectors (Sydney: Reserve Bank of Australia, 2008), 20.

[21] Christopher Joye and Joshua Gans, '*AussieMac*', 19.

[22] Australia-New Zealand Shadow Financial Regulatory Committee, *Mortgage Markets After the Sub-prime Crisis*, Statement Number 4 (19 June 2008).

[23] Jonathan Kearns and Philip Lowe, 'Promoting Liquidity: Why and How?' in *Lessons from the Financial Turmoil of 2007 and 2008* (Sydney: Reserve Bank of Australia), 22.

[24] Joe Nocera, 'A Mission Goes Off Course,' *New York Times* (23 August 2008).

[25] Peter Wallison, Thomas Stanton, and Bert Ely, *Privatising Fannie Mae, Freddie Mac, and the Federal Home Loan Banks*, 12.

[26] W. Scott Frame and Lawrence White, 'Fussing and Fuming over Fannie and Freddie: How Much Smoke, How Much Fire?' *Journal of Economic Perspectives* 19:2 (Spring 2005), 180.

[27] Peter Wallison, Thomas Stanton, and Bert Ely, *Privatising Fannie Mae, Freddie Mac, and the Federal Home Loan Banks*, 16.

[28] Ian Macfarlane, 'Statement by the Governor, Mr Ian Macfarlane: Monetary Policy,' Reserve Bank of Australia (2 August 2006).

[29] Christopher Joye and Joshua Gans, '*AussieMac*', 3.

[30] W. Scott Frame and Lawrence White, 'Fussing and Fuming over Fannie and Freddie,' 165–166.

[31] Peter Wallison, Thomas Stanton, and Bert Ely, *Privatising Fannie Mae, Freddie Mac, and the Federal Home Loan Banks*, 4–5.

[32] RBA Assistant Governor Guy Debelle, 'Open Market Operations,' (address to the Australian Debt Markets Conference, Sydney, 27 June 2008).

[33] Christopher Joye and Joshua Gans, *AussieMac: Postscript*, 8.

[34] Jonathan Kearns and Philip Lowe, 'Promoting Liquidity: Why and How?' 31.

[35] Ron Feldman, 'Uncertainty in Federal Intervention.'

[36] Peter Wallison, Thomas Stanton, and Bert Ely, *Privatising Fannie Mae, Freddie Mac, and the Federal Home Loan Banks*, 13.

[37] 'Fannie the Centaur,' *Wall Street Journal* (17 December 2004).

[38] 'Freddie's Friends on the Hill,' *Wall Street Journal* (27 April 2006).

[39] 'Fannie Mae's Political Immunity,' *Wall Street Journal* (29 July 2008), A16.

[40] W. Scott Frame and Lawrence White, 'Fussing and Fuming over Fannie and Freddie,' 164.

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