



The Global Importance of Government Guarantees in Mortgage Finance

An Analysis of How Guarantees Work in Different Developed Nations

David Min May 2012

Introduction

Critics of the federal government's role in the mortgage markets often claim the United States is unique among developed countries in providing significant guarantees for home mortgage financing.¹ A corollary to this critique is that European countries do not provide government guarantees for mortgage finance. Both of these statements are wrong, because they fail to understand the ways in which other countries, particularly European ones, support their residential mortgage markets.

Those who believe the United States is unique in supporting its mortgage finance system focus on the government backing of the mortgage securitization entities Fannie Mae, Freddie Mac, and Ginnie Mae, which together account for about half of all outstanding U.S. home loans (about 90 percent since the 2008 financial crisis). These three institutions purchase and pool mortgages meeting certain standards and sell the cash flows from these mortgage pools to investors in the form of mortgage-backed securities, backed by a government guarantee.²

Critics of the government's role in the U.S. housing finance market note that the United States is one of only a handful of countries that offer such guarantees for securitization—the others being Canada, Japan, and South Korea. What this argument ignores is that securitization is not an important source of mortgage finance for most of the world's developed countries.

In Western Europe, for example, traditional bank lenders—funded by deposits and, to a lesser extent, covered bonds (a type of bond that is collateralized by mortgages held by the issuing bank)³—are the primary source of residential mortgage finance. Conversely, securitization is not a major source of mortgage funding for any of these countries. Thus, it makes no sense to focus on guarantees for securitization, while ignoring guarantees for these bank obligations, when considering whether European governments provide support to their residential mortgage markets.

What does make sense is to examine the ways in which European governments do guarantee residential mortgage funding, both explicitly and implicitly. This issue brief will do just that—detailing the several ways the U.S. government guarantee on residential mortgages works and then comparing those processes with the very different but equally important government role in guaranteeing home mortgages across Europe.

The U.S. guarantee in mortgage markets takes several forms

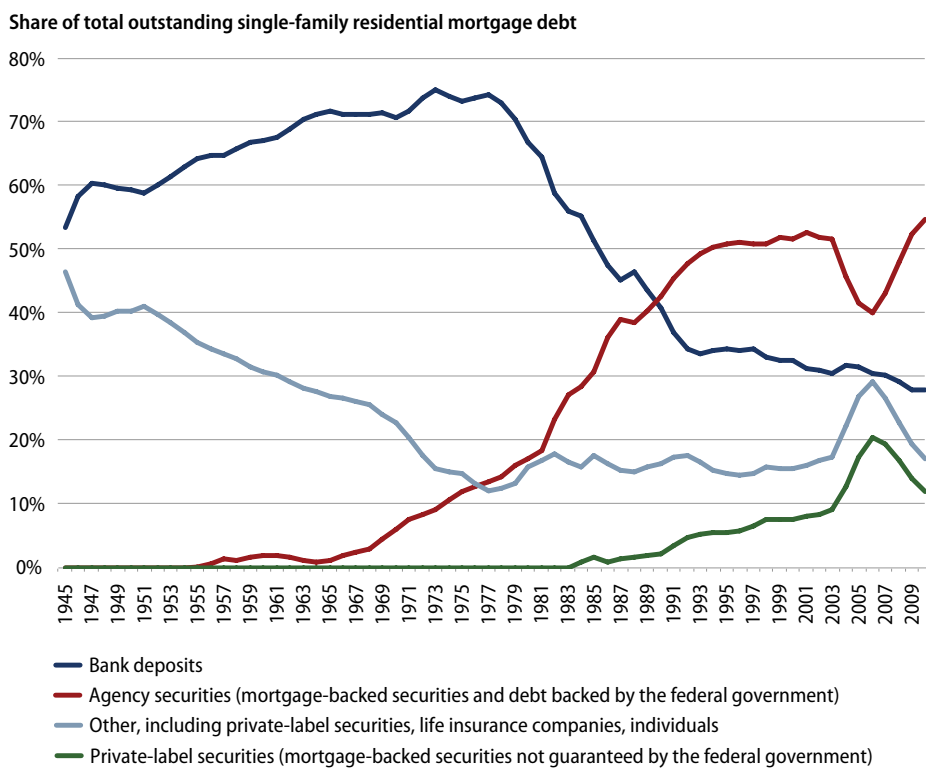
The federal government’s role in mortgage finance takes several different forms, the most important being:

- A federal guarantee behind so-called “agency securities,” or the mortgage-backed securities and bonds issued by Ginnie Mae, Fannie Mae, and Freddie Mac
- A federal guarantee on deposits at banks, thrifts, and other federally regulated depository institutions used to finance home mortgages and other important forms of lending⁴

Currently, the guarantee behind agency securities is the primary way in which the federal government backstops the U.S. mortgage system. Agency securities have financed more than half of all outstanding residential mortgages, including 90 percent of all mortgages originated since the 2008 financial crisis.

But agency securities did not always dominate the U.S. mortgage system. For most of the 20th century, up until the early 1980s, deposits at banks and thrifts were the major source of U.S. mortgage finance, funding more than 70 percent of all home loans held on the lenders’ balance sheets. These deposits were guaranteed by federal deposit insurance, introduced during the New Deal to ensure a broad and constant source of mortgage funding. (see Figure 1)

FIGURE 1
The changing face of U.S. residential mortgage finance
 Share of outstanding residential mortgages, by financing channel



Source: Federal Reserve Flow of Funds

European governments guarantee banks, not mortgage-backed securities

Those who claim that the United States is unique in supporting its mortgage finance system focus almost entirely on guarantees for securitization.⁵ They note that European governments do not provide guarantees for mortgage-backed securities analogous to U.S. guarantees for agency securities.⁶ But this analysis ignores a few key facts:

- Unlike in the United States, securitization is not the major source of mortgage funding in any European country.
- Bank obligations—most notably deposits and, to a lesser extent, covered bonds—provide the vast majority of European mortgage financing.
- European governments provide enormous levels of support through explicit and implicit guarantees for these bank obligations.

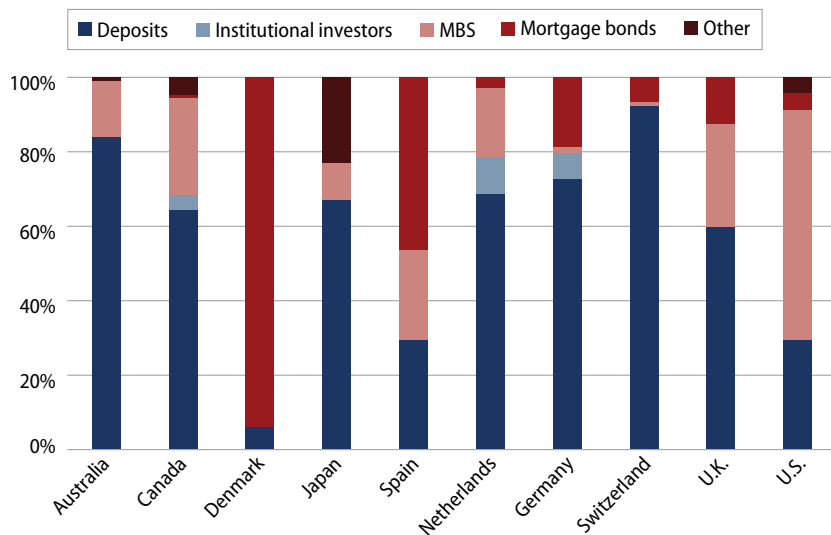
Let's look at each of these points in more detail.

Mortgage-backed securities are not an important source of mortgage funding in Europe

One of the leading critics of the U.S. mortgage finance system, San Diego State University professor Michael Lea, has correctly noted that European governments don't provide guarantees in mortgage finance. But what Lea has ignored—something aptly illustrated by his own chart, reproduced here as Figure 2—is that mortgage-backed securities aren't a particularly important source of financing in Western European countries. In Germany and Denmark, for example, the market share of mortgage-backed securities is essentially negligible, while in the United Kingdom and Spain, mortgage-backed securities play a larger but still far less important role than other sources of mortgage financing. (see Figure 2)

In other words, it isn't particularly important that European governments don't guarantee securitization because this is not a major source of mortgage funding in European countries.

FIGURE 2
Sources of mortgage finance are different in Europe
Mortgage funding channels in select European countries



Source: Michael Lea, "International Comparison of Mortgage Product Offerings," Research Institute for Housing America (2010)

Bank-issued obligations fund the vast majority of European mortgages

Figure 2 also provides us with another important insight, namely that in European countries most mortgage financing comes from bank obligations, namely deposits and, to a lesser extent, covered bonds (described as “mortgage bonds” in Figure 2). Bank deposits account for the lion’s share of all mortgage funding in virtually all European countries, including Germany, France, Switzerland, and the Netherlands. Covered bonds are also an important source of mortgage funding in Europe, funding virtually all mortgages in Denmark, and a healthy share of Spanish and German mortgages as well.

European governments guarantee the bank obligations that fund mortgages

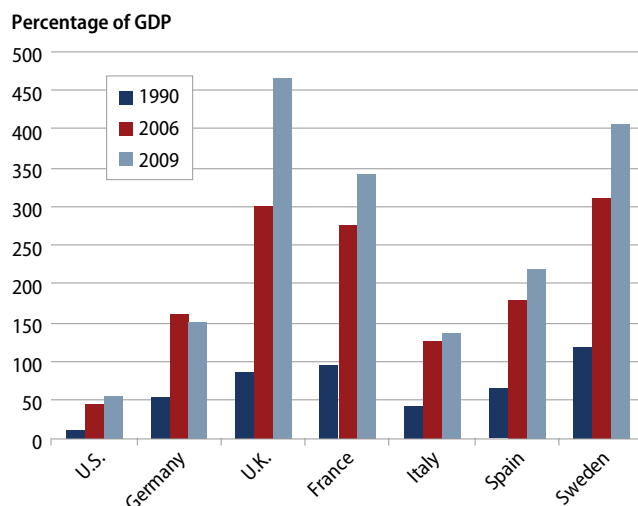
When we look at the bank obligations—deposits and covered bonds—that predominantly fund European mortgages, it is clear that these obligations enjoy government guarantees behind them. Just as the United States does, every country in the European Union provides explicit government guarantees behind bank deposits.⁷ Given that bank deposits are by far the most important source of mortgage funding throughout Europe, it is difficult to understand the claim that European governments do not support their mortgage systems.

Moreover, European governments also provide implicit guarantees, in the form of “too big to fail” guarantees, for the nondepository liabilities, which include covered bonds, of their banks. While the notion of “too big to fail”—the idea that certain banks are so systemically important that their unsupported failures would cause enormous financial and economic damage—is a relatively recent phenomenon in the United States, it has been a mainstay of European banking for many years.

Indeed, the high degree of banking concentration that is associated with “too big to fail” is both exponentially greater and has been around for many more years in Western European countries than in the United States. (see Figure 3)

As a result, it is well understood that European banks enjoy an implied government guarantee on their nondepository liabilities. As one anonymous European Central Bank official has famously stated, “We don’t let banks fail. We don’t even let dry cleaners fail.”⁸

FIGURE 3
Leading indicator of “too big to fail” financial institutions
Share of combined assets of top five banks as percentage of the economy of select nations



Source: Morris Goldstein and Nicolas Veron, *Too Big to Fail: The Transatlantic Debate* (2011)

This observation is well supported by the actions of eurozone governments during the 2008 financial crisis. Bank bailouts during the fall of 2008 were enormous and ubiquitous. Any doubt that European governments did not stand behind the obligations of their banks should have been erased following this tsunami of bailouts. (see Figure 4)

FIGURE 4

European bank bailouts during the 2008 financial crisis

Select list of banks and bank rescue packages for a number of banks rescued by their governments

Country	Bailout	Amount	Type
Belgium, France, Luxembourg	Dexia bailouts (Oct. 2008, Oct. 2011)	€100 billion	2008: Initial recapitalization of €6.4 billion; 2011: €4 billion nationalization of Belgian sub; €90 billion in guarantees.
Belgium, Netherlands, Luxembourg	Fortis bailout (Sept. 2008)	€11.2 billion	Recapitalization of €11.2 billion + liquidity guarantees.
Canada	IMPP (Oct. 2008)	\$125 billion	Purchase of insured mortgage pools to ensure liquidity
Denmark	Roskilde Bank nationalization (Aug. 2008)	\$8.3 billion US (41.8b kroner)	Nationalization of Denmark's eighth largest bank
Denmark	Financial Stability Act (aka Bank Package I, Oct. 2008)	Unlimited	2 year blanket guarantee on all obligations of Danish banks
Denmark	Bank Package II (Jan. 2009)	\$17.1 billion US (100b kroner)	100 billion kroner recapitalization fund
European Central Bank	Covered Bond Purchase Programmes (June 2009, Oct. 2011)	€100 billion	€60 billion for covered bond purchases in June 2009, €40 billion in Oct. 2011, to ensure liquidity in these instruments.
France	SFEF/SPPE (Oct. 2008)	€360 billion	€320 billion liquidity facility providing interbank lending guarantees, €40 billion recapitalization fund.
France	Natixis bailout (Oct. 2008)	€40 billion	€5 billion investment, €35 billion in guarantees on toxic assets
Germany	Financial Market Stabilization Act/SoFFin (Oct. 2008)	€480 billion	€400 billion for guarantees, €80 billion for recapitalization. Sunset December 2010, but reactivated Jan. 2012.
Ireland	Blanket guarantee (Sept. 2008)	Unlimited	Blanket guarantee on all obligations of Irish banks
Ireland	Nationalization of four (of six) banks (Jan. 2009 – July 2011)	€65 billion	Nationalization of Anglo Irish, Irish Nationwide Building Society, Irish Life & Permanent, Allied Irish Banks
UK	Nationalization of Northern Rock (Feb. 2008)	£100 billion	Nationalization of the UK's fifth largest mortgage lender after a £4.6b deposit run.
UK	Bank rescue plan (Oct. 2008)	£500 billion	£50 billion recapitalization fund, £250 billion in credit guarantees; £200 billion in short term loans to ensure liquidity.

Sources: Economic Times (2008), The New York Times (2008) (2011), BBC News (2008), Forbes (2008), European Union, European Central Bank, RFI, BaFin (German Federal Financial Authority), The Wall Street Journal (2008) (2011) (2012), HM Treasury's National Audit Office.

Since bank deposits are already explicitly guaranteed in all European countries, this implicit “too big to fail” guarantee primarily ensures the nondepository liabilities of banks, including covered bonds. The existence of this implicit government guarantee is a critical factor for investors in European covered bonds, and is explicitly built into the credit ratings awarded to covered bonds.⁹

Indeed, the recent sovereign debt crises in many European countries have been the primary driver of ratings downgrades for covered bonds, further indicating the importance of government support for these financial instruments.¹⁰ In one form or another, government guarantees are at least as important to residential mortgage markets in Europe as in the United States. (see Figure 5)

FIGURE 5
Different forms of government guarantees on mortgages in the United States and Europe

A select list of countries and the government agencies that explicitly or implicitly guarantee residential home mortgages

Country	Government guarantee on mortgage insurance?	Government guarantee on securitization?	Government guarantee on bank deposits?	Government guarantee on covered bonds?
USA	Yes, FHA (explicit)	Yes, Ginnie (explicit), Fannie/Freddie (implicit)	Yes, FDIC (explicit)	Possibly, “Too big to fail” (implicit)
Canada	Yes, CMHC (explicit)	Yes, CHMC (explicit)	Yes, CDIC (explicit)	Yes, “Too big to fail” (implicit)
Denmark	No	No	Yes, GII (explicit)	Yes, “Too big to fail” (implicit)
France	No	No	Yes, FGD (explicit)	Yes, “Too big to fail” (implicit)
Ireland	No	No	Yes, Central Bank of Ireland (explicit)	Yes, blanket guarantee on all Irish bank obligations (explicit)
Spain	No	No	Yes, FGD (explicit)	Yes, “Too big to fail” (implicit)
UK	No	No	Yes, FCSC (explicit)	Yes, “Too big to fail” (implicit)

Source: Author’s research of FDIC, CDIC, GII, FGD, Central Bank of Ireland, FGD, FCSC

Conclusion

It is clearly incorrect to state that European countries don’t provide government support for their mortgage markets. European governments do not guarantee mortgage securitization in the same way that the United States does, but at the same time, securitization is not an important source of mortgage financing for European countries. Rather, European governments guarantee the sources of funding that are most important for European mortgage finance—bank deposits, and to a lesser extent, bank-issued covered bonds.

This issue brief should put the false claims around this issue to rest.

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Endnotes

- 1 See, for example: Michael Lea, "International Comparison of Mortgage Product Offerings" (Washington: Research Institute for Housing America, 2010); Dwight Jaffee, "Reforming the U.S. Mortgage Market through Private Market Incentives" (University of California, Berkeley, 2011), available at <http://research.stlouisfed.org/conferences/gse/Jaffee.pdf>
- 2 This guarantee is explicit for Ginnie (the Government National Mortgage Association), a government-owned corporation, and implicit for Fannie (the Federal National Mortgage Association) and Freddie (the Federal Home Loan Mortgage Association), which are privately owned but with unique government charters. Fannie and Freddie also issue federally guaranteed corporate debt, which they use to purchase mortgage-related investments.
- 3 Covered bonds are actually "dual recourse," insofar as investors in these instruments have contractual rights to a dedicated pool of mortgage assets, as well as the other assets of the issuer. For purposes of this short brief, it suffices to note that covered bonds are bank-issued obligations and thus benefit from any implicit government guarantees of the banks that issue them.
- 4 There is also a federal guarantee on the mortgage insurance offered by the Federal Housing Administration and Department of Veterans Affairs.
- 5 See, for example: Lea, "International Comparison"; Jaffee, "Reforming the U.S. Mortgage Market." Lea also looks at whether other countries have government guarantees behind mortgage insurance, noting that the United States, the Netherlands, and Canada all provide government-guaranteed mortgage insurance. *Ibid.*
- 6 Government-backed securitization is also an important part of the housing finance systems of Canada, Japan, and Korea. See: Lea, "International Comparison," pp. 12–14 ("Canada and Japan have government guarantee programs [for MBS]. ... Korea has a GSE modeled after those in the United States.").
- 7 Directive 94/19/EC of the European Parliament requires all European Union member nations to have a government-backed bank deposit insurance scheme covering a minimum of €50,000.
- 8 David Wessel, *In Fed We Trust: Ben Bernanke's War on the Great Panic* (New York: Crown Publishing Group, 2009).
- 9 See, for example: Moody's Investor Service, "EMEA Covered Bonds: 2011 Outlook and 2010 Review" (2011), pp. 2, 4 ("[T]he expectation of government support for the country's banks" is an important factor in the ratings of covered bond issuers (which is a key element of covered bond ratings); government guarantees are also an important factor in assessing the refinancing risk, as "[s]tate support is normally an important source of liquidity for timely payments, [including] through repo facilities, provision of emergency finance or "bail-outs"); Standard & Poor's Financial Services LLP, "Covered Bonds: Revised Methodology and Assumptions for Assessing Asset-Liability Mismatch Risk in Covered Bonds," December 16, 2009, available at <http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245199921184> (noting that a key factor in determining covered bond ratings is "the role of the government in supporting a failing issuing bank's [covered bond] program").
- 10 See generally: Moody's, "EMEA Covered Bonds" (noting that sovereign ratings downgrades have been the "prime drivers" of covered bond ratings downgrades in 2010 and 2011, due to the lower value of the government guarantee behind covered bond issuers).