The Dark Side of Home Subsidies

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Home ownership in the United States ranks up there with motherhood and apple pie. The government has championed it for decades through tax breaks, mortgage guarantees and, most recently, the herculean task of keeping Americans in their homes after the housing market collapse. But government subsidies of the American Dream also have a darker side: when things head south, taxpayers end up stuck with the costs.

The government-run mortgage finance agencies Fannie Mae and Freddie Mac owned more than 131,000 properties between them at the end of 2009, according to recent annual filings. That's roughly the equivalent of San Francisco's owner-occupied housing stock. The two companies sold off nearly 200,000 units last year that they took over after owners defaulted. But despite those efforts, Fannie and Freddie owned substantially more units at the end of 2009 than they did a year earlier.

And things are set to get worse. **Barclays** Capital estimates the pipeline of severely troubled loans at around five million across the United States. Modification programs, which should help some borrowers stay in their homes, have also delayed the inevitable forfeiture of many others.

Fannie and Freddie end up owning properties because they provided guarantees for the benefit of mortgage investors. Between them, they back around $5 trillion of American home loans. Such support — once implicitly and now explicitly backstopped by the **Treasury** — has handed borrowers relatively low financing costs for years.

Now, though, the result is that aside from the huge financial burden they place on taxpayers, the two companies have been amassing foreclosed properties and, in a few cases, have become landlords.

It's a tiny part of their operations for now. But if the housing market doesn't turn around soon, the companies could find themselves reluctantly managing more properties. And no one expected, or wanted, Fannie and Freddie to become giant public-sector landlords.

The immediate task is to clean up the mess, but policy makers need to think about the longer term. That means recognizing that the policy benefit of subsidizing home ownership has reached its limit, and starting to take the government out of the mortgage guarantee business altogether.

Contingency Planning

Ever since the financial crisis struck, regulators the world over have argued for an overhaul of bank capital. So-called contingent capital, which can absorb losses while keeping a bank in business, was promoted as a solution in the United States and elsewhere.

But until last week it had been used by only a few distressed lenders and enthusiasm seemed to be waning.

The decision by Rabobank — one of the world's most highly rated banks — to issue contingent capital securities could reinvigorate the idea. Rabobank, based in the Netherlands, is the first healthy European lender to sell the securities to investors as a new issue.

Bankers hope contingent capital can replace older hybrid securities that combine characteristics of debt and equity. These were popular during the boom because they counted toward banks' regulatory capital but did not dilute shareholders. But during the crisis, they failed to help banks absorb hits to their capital.

Contingent capital instruments address this problem by converting into some form of capital if a bank's reserves fall below a predetermined level. Lloyds Banking Group last year issued bonds that would convert into shares at a set point. But it did so as part of a debt exchange that gave investors a strong incentive to convert.

Rabobank's securities are different. Rather than converting into equity when the bank's capital runs low, they would automatically be written down to 25 percent of their face value and repaid. That would reduce Rabobank's liabilities, allowing it to book a profit, which in turn would raise its capital.

It's a tryout for a new version of contingent capital. But it's not clear how much of a market there is for this kind of debt. One problem is how to price it. If Rabobank's securities were written down, investors would suffer a loss with no prospect of future recovery. The fact that the bond is unrated will also deter some buyers.

So while Rabobank's offering takes the market for contingent capital one step forward, it won't be the last word. It will still take some time before the contingent capital theory converts into reality.