Statement before the House Committee on Financial Services
Subcommittee on Housing and Insurance
On

Sustainable Housing Finance

Peter J. Wallison
Senior Fellow and Arthur F. Burns Fellow in Financial Policy Studies

November 7, 2017

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Chairman Duffy and Ranking Member Cleaver:

I am grateful to the Subcommittee for the opportunity to testify today. In its invitation letter, the Subcommittee asked for my "perspective on the need for comprehensive housing finance reform, the legal, statutory or regulatory impediments to the return of private capital to the housing finance system and what factors and metrics Congress should consider to reform the housing finance system."

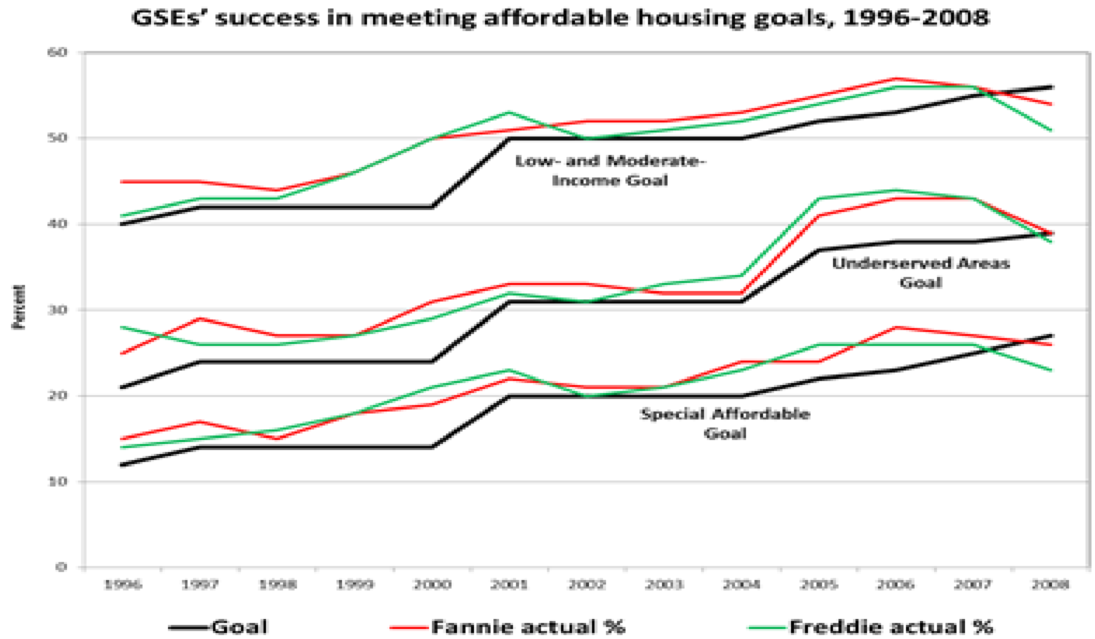
My view is that the best and most effective housing finance reform would be to completely eliminate the government's role in housing finance, and to let private capital and the private sector operate the housing finance system. There is nothing about the way the government has managed the housing finance system for the last 50 years that would remotely recommend a continuing government role.

Later in this testimony, I will show that the government's policies—and particularly those implemented by the government-sponsored entities (GSEs) Fannie Mae and Freddie Mac—have done nothing to advance home ownership. In fact, they have seriously impeded the growth of home ownership in the United States and continue to do so in the government conservatorship that currently controls them. But first, I want to describe briefly the relationship between government housing policies and the 2008 financial crisis—a genuine catastrophe for the US and world economy that was caused directly by the US government's housing policies.

In 1992, Congress adopted a program called the Affordable Housing Goals. These required the GSEs to meet an annual quota of low and moderate income (LMI) mortgages when they purchased mortgages from banks and other originators. Initially, the goal was 30%—that is, in any year, 30% of all the mortgages Fannie and Freddie acquired had to have been made to borrowers at or below median income where they lived.

Before 1992, the GSEs acquired only prime mortgages, and this was thought by community activists and many in Congress to have limited the ability of LMI borrowers to buy homes; the goals were adopted to address this concern. Although the initial quota was 30%, HUD was given authority to increase the goals in later years. Beginning in 1996, and continuing until 2008, HUD aggressively increased the goals, so that by the year 2000 the goal was 50%, and by the year 2008 it was 56%. This meant that in 2008, more than 50% of all mortgages the GSEs acquired had to be made to borrowers who were at or below median income. The chart below shows the increase in the goals between 1996 and 2008, together with the GSEs' compliance through 2008. As can also be seen from the chart, the sharpest increases in goals occurred in the Underserved and Special Affordable categories, thus requiring ever greater loosening of credit standards.

The chart shows clearly that as the goals increased over these years, so did the GSEs' purchases of mortgages made to borrowers at or below the median income.



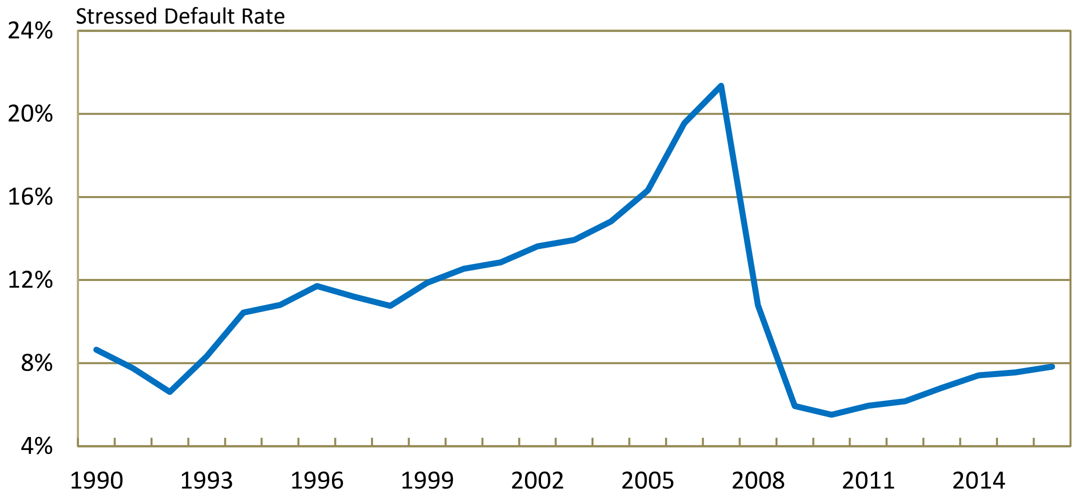
Source: FHFA

As the goals increased, the GSEs could not find a sufficient number of prime mortgages to meet the goals, and they began to reduce their underwriting standards. The most significant change was a reduction in the downpayment they were willing to accept. Although a prime mortgage usually required a 10 to 20% downpayment, beginning the mid-1990s the GSEs began to accept 3% downpayments, and by 2000 they were accepting 0% downpayments.

Because the GSEs were the dominant players in the housing finance market, acquiring almost 50% of all loans during the boom years, their willingness to acquire loans with low downpayments meant that banks and other originators could make those loans and still sell them to the GSEs. In fact, top officials of the GSEs were telling the banks that they wanted those loans to meet the goals. In addition, and importantly, there was no way to limit the lower underwriting standards and downpayments to LMI borrowers. By the year 2000, 30% of the mortgages with low down payments that the GSEs were acquiring were made to borrowers above the median income. In this way, underwriting standards throughout the housing market declined.

The chart below, which uses internal FHFA data in part, shows how the risks of the GSEs increased over the period after the adoption of the goals 1992. It is important and telling to note how closely the increase in the GSEs' risks matches the growing bubble in housing prices.

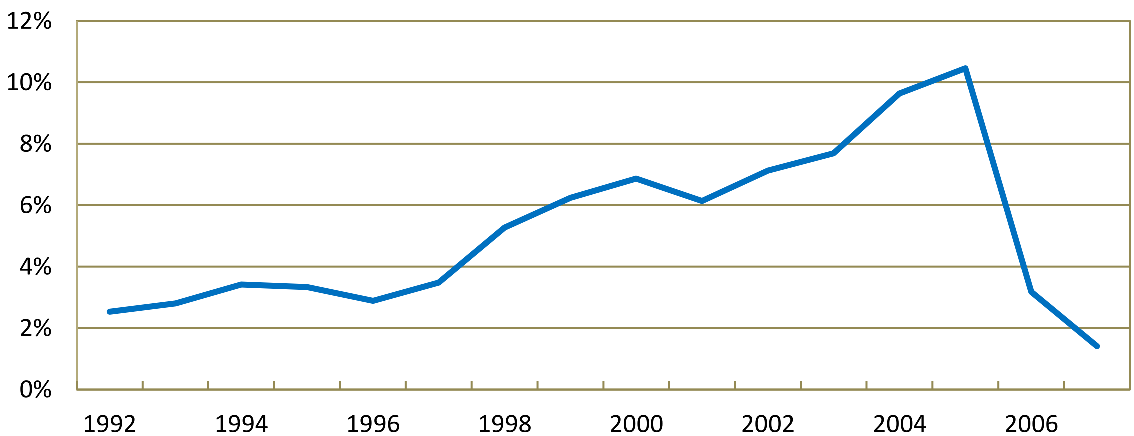
Historical Mortgage Risk Index for GSE Purchase Loans



Note: Data pertain to 1-4 unit, first-lien home purchase loans. Source: Internal FHFA data.

Low downpayments mean that home buyers use more leverage to buy homes—that is, they borrow more to buy more expensive houses. For example, if a potential buyer has $10,000 to buy a home and the downpayment required is 10%, the buyer can purchase a $100,000 home. But if the downpayment becomes 5%, the buyer can purchase a $200,000 home with the same $10,000 downpayment. He simply borrows $190,000, instead of $90,000. This additional leverage puts upward pressure on housing prices—and that is exactly what happened, beginning in the mid-1990s, as the GSEs reduced their underwriting standards in order to meet the goals. This is clearly shown in the chart below.

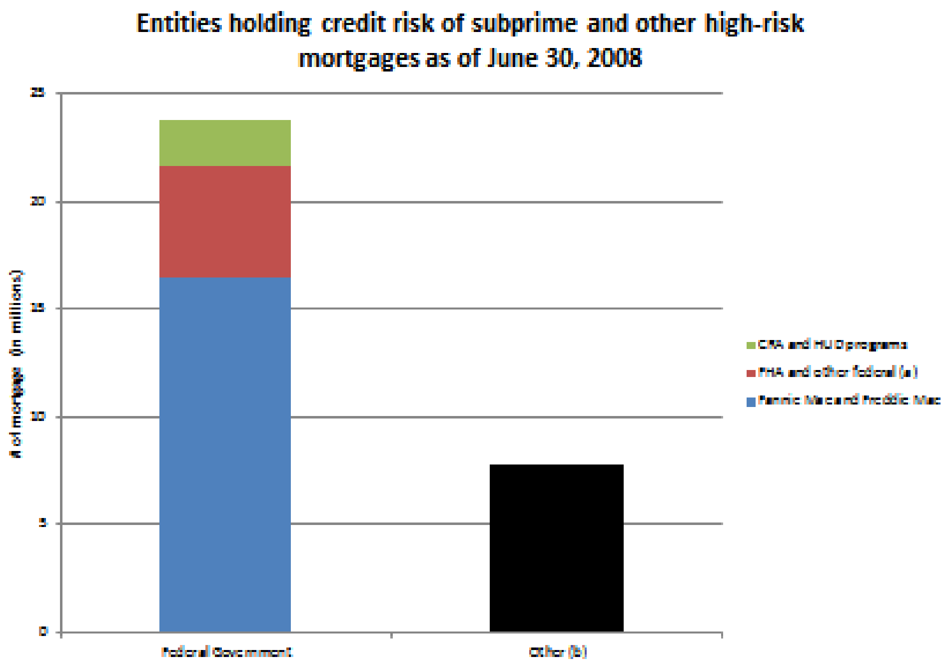
House Price Increases: 1992 - 2007



Note: Chart displays percent change from fourth quarter of prior year to fourth quarter of year shown for U.S. as a whole.
Source: FHFA expanded-data house price index.

As a result, throughout the late 1990s and into the 2000s, the GSEs became avid buyers of subprime and Alt-A mortgages, including private mortgage-backed securities (PMBS) secured by mortgages within the conforming loan size limits. Between 2003 and 2006, the peak years of the housing bubble, Fannie and Freddie acquired about 50 percent of all Alt-A loans and 40 percent of all subprime loans originated nationally (including both whole loans and PMBS backed by Alt-A and subprime loans). This included about 25 percent of all the AAA rated PMBS backed by prime, subprime, and Alt-A mortgages and about 43 percent of all PMBS (whether or not rated AAA) backed by subprime and Alt-A mortgages. Since the GSEs were limited to PMBS backed by mortgages within the conforming loan limits, their percentage of conforming subprime and Alt-A PMBS was certainly well above 50 percent.

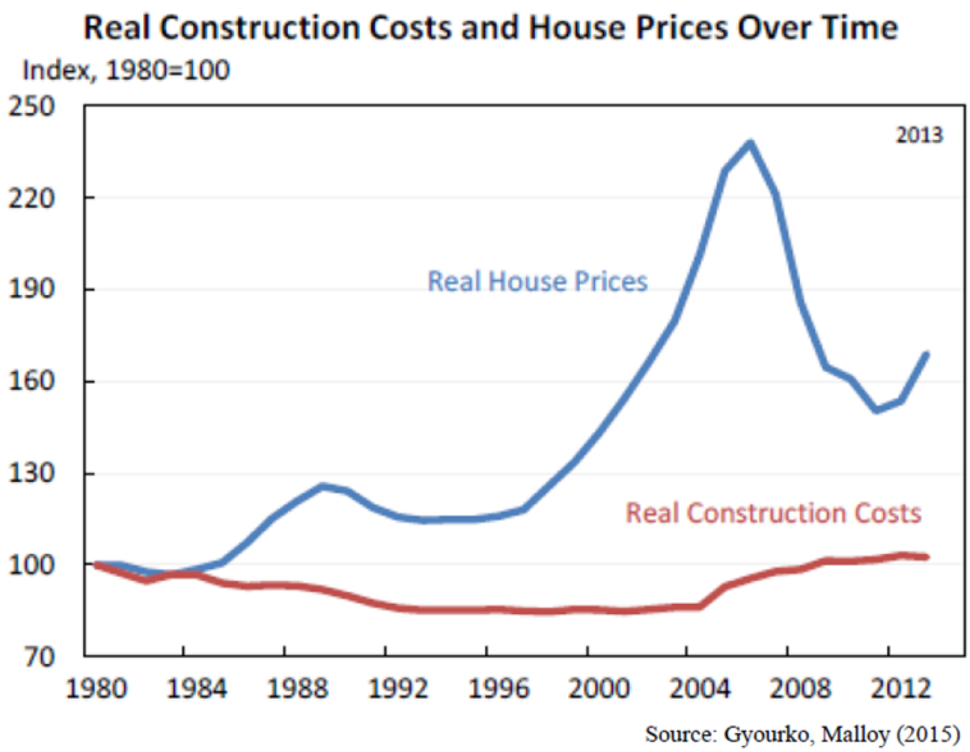
By 2008, more than half of all mortgages in the US were subprime or Alt-A, and 76% of them were on the books of government agencies, primarily Fannie and Freddie, as shown in the graph below. The other government holders were FHA and other HUD programs. This shows, without question, that it was the government that created the demand for these mortgages, causing the unprecedented housing price bubble and the 2008 financial crisis when the bubble collapsed. In addition, of course, the financial crisis caused billions of dollars in losses for US taxpayers and—because the crisis was falsely blamed on insufficient regulation of the financial system—it was also responsible for the enactment of the Dodd-Frank Act, which caused 8 years of slow growth for the US economy.



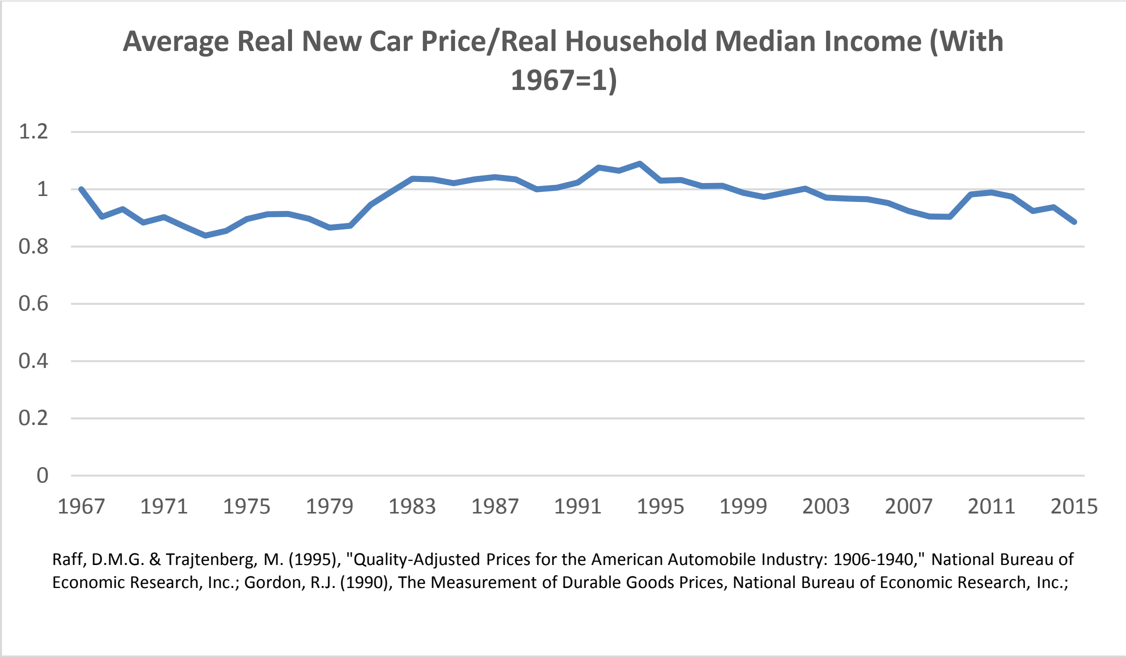
(a) "FHA and other federal" Includes VA, Dept. of Agriculture, FHLBs, and others
(b) "Other" Includes subprime and Alt-A private MBS Issued by Countrywide and Wall Street 1

Notwithstanding trillions of dollars in direct and indirect subsidies, the current homeownership rate of 63.9% is statistically no different than the average rate of 64.3% since 1964 (excluding the bubble years). Thus, the US government's housing policies over all these years have failed to provide a reliable and stable system of economical or affordable housing all Americans, and particularly for moderate and low income homebuyers. The United States, a country which has grown to world dominance because of its free and innovative economy, is the only developed country with a housing finance system completely dominated by the government. Yet, amazingly, in spite of all the funds the government spends on subsidizing housing—including various tax benefits—the US ranks only 17th among developed countries in home ownership.

The chart below really tells the whole story. We can see the enormous bubble between 1997 and 2007, but during the same period the bubble was growing housing construction costs were stable. The difference between the two is that the government controls the housing finance system, while the government has no role in housing construction. Construction costs, instead, are negotiated between developers and contractors.



In case anyone thinks that the housing market is an anomaly because it is so large, the chart below shows the US automobile market—another market where the government has no role, and pricing is based on negotiation between consumers and manufacturers. As the chart shows, prices in that market have remained stable in terms of median household income even though the quality of automobiles has improved markedly over this period.



Accordingly, anyone who looks at the US housing market today can tell that it is badly afflicted by government control and government policies. For that reason, a sound housing finance reform would simply eliminate Fannie Mae and Freddie Mac. This would go a long way toward creating the kind of stable market in which—as in the auto market—the private sector produces what the public demands at a price the public is willing and able to pay.

Nevertheless, those who want continued government involvement in housing finance support their position by claiming a lot of benefits that can be proven to be false. Once this is clear, it also becomes clear that the government should have no significant role in the housing finance system, and that should be the recommendation of this committee.

Because the GSEs are the principal element of the government's policies, I'll focus in the rest of this testimony on what they do and what effect their actions have. The same arguments generally apply to FHA, although a smaller, carefully controlled, government role in assisting low income borrowers could have some value.

a. The GSEs do not reduce interest rates

Two facts are largely unknown even to those who regularly participate in the debate over housing finance policy. First, our analysis at AEI shows that since 2014—even after controlling for the risk characteristics of the mortgages—the private market (primarily banks acquiring mortgages for portfolio) has been offering mortgage loans with *lower* interest rates than the GSEs. Accordingly, despite their government backing and the subsidies and costs that entails, the GSEs do not offer lower rates than banks and other portfolio lenders.[1] This will certainly come

[1] Since 2014, jumbo rates on closed 30-year term loans have been about 25 basis points below GSE rates for loans with the same risk characteristics. See: Jumbo-GSE Rate Spreads Before, During, and After the Financial Crisis presented at the Sixth Annual AEI-CRN Conference on Housing Risk. Unpublished research found similar risk adjusted rate differentials on smaller balance loans, loan term, various LTV bands, and loan tenure.

as a surprise to the members of Congress who have been told for years by the Housing Lobby that the GSEs' lower mortgage interest rates were helping put Americans in homes.

In addition, as noted above, the private sector mortgages that we compared to GSE mortgages were 30 year fixed rate loans, which are readily available from private sector lenders without a government guarantee. Many members of Congress have been told by the Housing Lobby over the years that there would be no 30 year fixed rate mortgages without government backing, but our research—described above—shows that this is false.

In saying this, I do not mean to imply that a 30 year fixed rate mortgage is a good idea for a family. It is not. It is favored by Realtors and homebuilders because—by lowering the monthly mortgage payment—it increases home prices and thus their profits, but it prevents families from developing equity in their homes. Indeed, a buyer could get a lower interest rate by negotiating a 15 or 20 year mortgage, because the build-up of equity on these mortgages in the early years decreases their riskiness to the lender.

b. GSEs do very little to help low or moderate income families buy homes

This will certainly be another surprise to members of Congress who have been told that the GSEs were the mainstays of a housing finance system that was directed at increasing home ownership. It turns out that only a small percentage of GSE activities is involved in helping people buy first homes, especially LMI borrowers; most of what they do is refinance mortgages—something that the private sector could easily do.

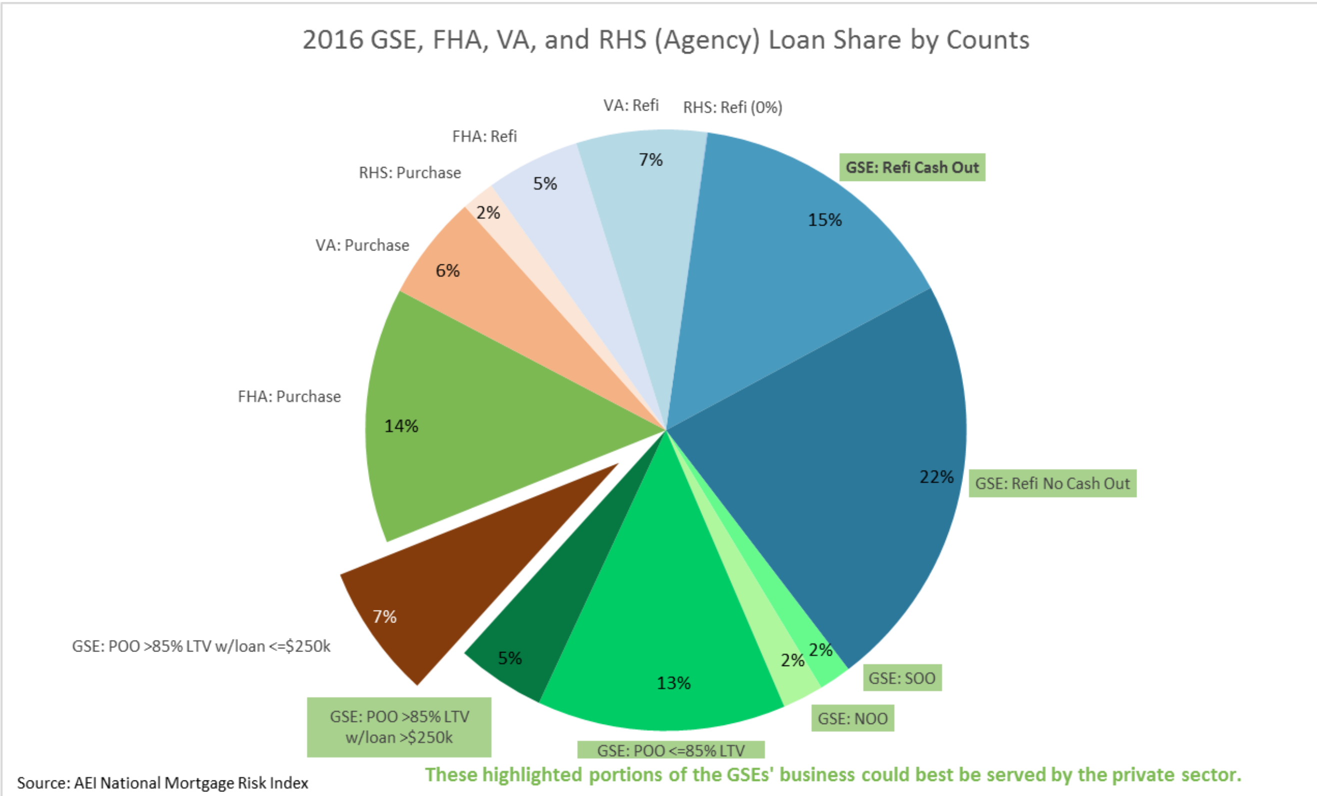
The pie chart below shows all the government's activity in housing finance, including loans for both purchasing and refinancing a home. For the purpose of this discussion, I will focus only on those families taking out loans for less than $250,000 with a downpayment of less than 15 percent.[2] I think everyone would agree that the families trying to buy a home in this range are the ones who we should most want to help through government policies. Half of these households have an estimated income below $66,000, which is 120 percent of US median household income.[3]

As the chart below shows, GSEs' activities in helping these families buy homes are only 7% of all the government's residential finance activities, and that is only 11% of all GSE home finance activity. So the taxpayers are at risk for about $5 trillion in GSE debt in order to help only 7% of those LMI borrowers whom the government should most want to help. Indeed, as I pointed out earlier, the GSEs' policies actually drove up housing prices and thus hurt, rather than helped, LMI as well as other borrowers.

About 18% (or 27% of total GSE activity) were home purchase loans greater than $250,000, with a median borrower income of $122,000 or with downpayments of 15 percent or less. The median sales price for a US home in 2016 was around $275,000. These were loans that could easily have been made by the private sector. The GSEs were not necessary to help these

[2] A $250,000 mortgage with less than 15 percent down represents a downpayment of about 10 percent and a sales price of about $275,000, slightly above the median sales price for new and existing homes purchased in 2016.
[3] Source: HMDA 2015

homebuyers, especially when the GSEs do not—as noted above—reduce interest rates. They would get a better deal borrowing from a bank or credit union.



Note: POO: Primary Owner Occupied, SOO: Secondary Owner Occupied or second homes, and NOO: Non-Owner Occupied.

As noted earlier, the balance of the GSEs' activity is involved with refinancing of mortgages, financing second homes (second owner occupied, SOO), or financing investor purchases of houses (non-owner occupied, or NOO) which are used for rental. This GSE activity, which was 41 percent of all government activity (and 62 percent of total GSE activity), involved cash-out and other refinances, non-owner occupied loans, and loans on second homes. None of these activities contributes to home ownership by the families who want to buy a first home, and all of these activities can be done by the private sector at rates commensurate with the risks they reflect; there is no reason the government should subsidize these products or that the taxpayers should be burdened with the risks and costs they entail.

The GSEs' cost to the Treasury. All this GSE activity, which has nothing to do with promoting home ownership, is very costly to the Treasury and thus to the taxpayers. The GSEs and their supporters often argue that because many investors, including foreign central banks, are required to invest only in sovereign or sovereign-guaranteed debt, the GSEs have a ready market around the world. This is often treated as a great benefit—attracting global credit to the US housing market—but it is actually a burden for the taxpayers. Because the GSEs' debt pays slightly more than Treasury securities, and is regarded as a legal investment for many sovereign and private investors that are restricted to acquiring only sovereign debt, it is often a *substitut*e for Treasury securities. This means that to the extent that the GSEs sell debt abroad—or even in the US—they are reducing the demand, and thus increasing the interest costs, of US Treasuries.

Our calculations show that competition from the GSEs' debt costs the Treasury about $17 billion to $29 billion each year. The GSEs' small contribution to assisting buyers of more modest homes cannot possibly justify the GSEs continued dominance of the housing finance market, free taxpayer support, or this large a cost to the US Treasury.

c. The GSEs and other housing policies increase housing prices and makes homes less affordable

US housing policy has created a housing finance system that is an "economics free zone," substituting government intervention and its inevitable market distortions for the price signals a true housing finance market would provide. This government-dominated system has promoted a massive liberalization of mortgage terms, countless trillions of dollars in lending, and many millions in home foreclosures, yet housing has become less—not more—affordable, and less—not more—accessible.

Mortgage underwriting standards, and not interest rates, are the key determinants of housing prices. To some extent, of course, all things being equal, housing prices will be higher in a market where interest rates are low, but the most important factor in housing prices is leverage—the amount of money that a home purchaser is able to borrow and still qualify for a mortgage.

Today, for example, the GSEs are willing to acquire mortgages with 3 percent (or even 1 percent[4]) downpayments, which—as described earlier—means that the homebuyer will be borrowing 97 percent or more of the price of the home. What this really means in practical terms is that the buyer reaches for the most expensive house that the loan puts within reach. This exerts strong upward pressure on home prices. The GSEs are also willing to accept mortgages from borrowers who have debt-to-income (DTI) ratios higher than 43 percent and recently announced a willingness to accept DTIs as high as 50 percent.[5] This increase in income leverage further accelerates housing prices.

As explained above, it is easy to see how this works to hurt first time home buyers. By subsidizing home ownership through tax benefits (deductibility of interest on mortgages) and other home ownership programs, the government increases demand; by subsidizing such agencies as Fannie and Freddie to acquire mortgages with low down-payments and high debt-to-income (DTI) ratios, the government increases the leverage in the housing market, which raises home prices.

Policies like this drive up housing prices and make houses less affordable for first-time home buyers. In 1989, nearly 90 percent of U.S. housing markets were rated as affordable (a median home price to median income ratio of 3.0 or less) with only 4 percent rated as severely

[4] http://www.chicagotribune.com/classified/realestate/ct-re-0618-kenneth-harney-20170614-column.html

[5] Desktop Underwriter/Desktop Originator Release Notes - Fannie Mae June 29. 2017

unaffordable (a ratio of greater than 5.0). However, fueled by 13 years of continuous growth in loan leverage, the median house price nationally increased from 2.86 times the median income at the end of 1992 to 4.05 times median income in 2006. After more than a decade of government affordable housing policies, when lending standards had been hollowed out, less than a third of markets were affordable, and 30 percent of markets were severely unaffordable. Today, after the collapse of house prices in 2008, the affordability index stands at 3.32, up from its low point of 3.03 in 2012, an increase of about 10%. Although homeownership hit a high of 69.2 percent in 2004, it now stands at 63.9 percent. The result of affordable housing policies? Higher leverage, a lower homeownership rate, and reduced affordability.

In the New York City and Los Angeles areas, affordability numbers are even worse, standing at 5.51 and 8.81, times median income, respectively.[6] This may be endurable for people who already own homes, since they will benefit from the rising prices in the market. They can sell their existing home and use the proceeds of sale for the purchase of another or larger home. But first time homebuyers—who have to scrape together the funds to buy a home—are the ones who are hurt by these policies which continuously drive home prices higher than incomes rise.

As of September 2017 we have had 61 straight months of a seller's market (defined by the National Association of Realtors as less than 6 months of housing inventory for sale). As a result, national real home prices are 28 percent above their 2012 trough. This is roughly the pace that eventually led to an enormous housing price bubble in 2007 and the financial crisis when the bubble collapsed in 2008. More ominously, prices on entry-level homes are rising at an even faster rate.

d. Government policies and low-income homeownership

For the reasons described above, the underwriting policies of the GSEs (and other government guarantee agencies) cause home prices to rise and make homes for low-income first-home buyers unaffordable. It is not too much to say that US homeownership policy—notwithstanding the countless trillions of dollars in home loans and the massive liberalization of credit terms—has completely failed to achieve its two primary goals: broadening access to homeownership, and achieving wealth accumulation for low- and moderate-income homeowners.

Government housing policies—implemented primarily through the GSEs, but also including the FHA, VA and others—try simultaneously to expand demand, increase liquidity and leverage, and provide subsidies to "fill in" the resulting "price or affordability gap." It is all, ostensibly, in the name of increasing home ownership, but that too has been a failure. In 1964, the homeownership rate in the US was 64 percent. It was still 64% in 1995. After HUD's aggressive increase in the goals quotas, beginning in 1996, the homeownership rate reached almost 70%. Then came the crash in 2008, and the homeownership rate in the US today is now 63.9%. So all the activities of the GSEs and other government agencies between 1992 and 2008 achieved nothing in terms a long term increase in homeownership, but it produced a financial

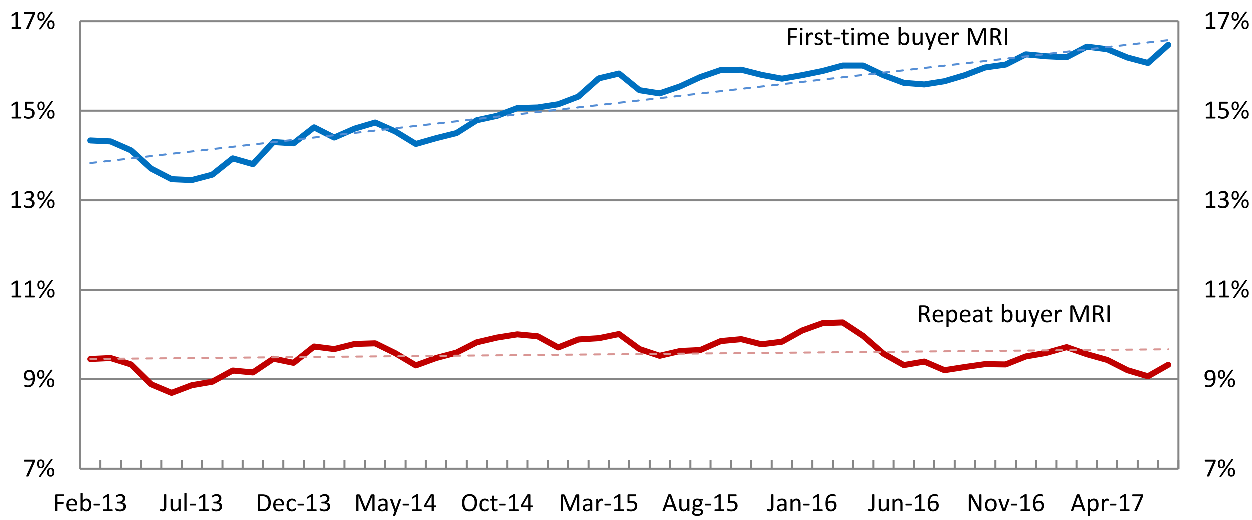
[6] Source: created by AEI scholar Ed Pinto where price is *ZHVI All Homes* series and income is seasonally adjusted *Median Household Income* series for all homes, https://www.zillow.com/research/data/

crisis, huge taxpayer losses, and legislation—in the form of the Dodd-Frank Act—that has given us almost a decade of slow economic growth.

The consequences were particularly dire for first-time low-income homebuyers. They were faced with rising prices that exceeded the increases in their incomes. The government attempted to mitigate the consequences of its policies by doubling down on them—pressing agencies like the GSEs to further reduce their underwriting standards, especially downpayments and debt ratios. Many of these buyers, lured into buying homes that they couldn't afford, lost their homes in the collapse of the housing bubble. .

The chart below shows that the same thing is happening again, with first-time buyers taking on more risk than repeat buyers. This is because the most substantial effect of the government's leverage policies occur at the first-time buyer level. Repeat buyers usually benefit from an increase in the value of the home they are selling.

Agency First-Time and Repeat Buyer Mortgage Risk Indices



Source: AEI International Center on Housing Risk, www.HousingRisk.org

e. The high cost loan limits are unnecessary and contribute to higher home prices

The purpose of the high-cost limits is to promote home buying in high cost areas. As noted earlier, the people who live in any of these areas do not need government help to buy homes. They have significant family incomes. But the way the high cost area loan limits work is to artificially raise housing prices by encouraging all buyers to make maximum use of what they believe—wrongly, as it turns out—is a government subsidy.

For example, in our work at AEI, we studied what happens when the GSEs' loan limits are raised. We found that the higher limits did little to spur new demand for homes. Instead, we found that as the limits were raised there was immediate bunching at the higher limit, and all the bunching at the lower limit disappeared. This suggests that the main effect of the high cost area limits is to induce borrowers to take out the maximum loan amount they can get to either increase the amount of their purchase price or to reduce their downpayment, or both. In either case, the benefits to homeownership are minimal; what occurs is an increase in home prices.

Because the shift that occurs is instantaneous, the system is likely gamed by borrowers/realtors/loan officers, who suggest to buyers that the higher limit offers a subsidy that they should not miss using. This conclusion is reinforced by further research that found that about one-third of GSE high cost area loans have LTVs in excess of 80 percent vs. only 17 percent of private loans in the same high cost areas, suggesting that buyers stretched for more debt under the high cost limits to buy more expensive homes.

Conclusion

It is not possible to arrest this process when the government controls the housing finance system, as it does today.

The government itself has strong incentives to take and keep control of the housing finance system. One of the quickest ways to boost economic growth is to increase the sale of homes. This promotes the purchase of rugs, furniture and construction materials, spurs employment, and can be presented as realizing the American dream.

The result is always the same. A housing boom feeds on itself as buyers, lenders, and government guaranty agencies conclude that the growth will continue and thus the risks of lending and borrowing are low; and the boom continues until house prices are so high that no amount of concessionary lending will enable buyers to pay for them. Then the decline begins, as it did in 2007, and large percentages of first-time buyers lose their homes and whatever downpayments they made—and/ or taxpayers suffer a loss bailing out the government agencies like the GSEs that bought the risky mortgages.

The only way to stop this process is to gradually remove the government from the housing finance system. What will happen then is that the private sector will gradually return to create a market in which prime mortgages will predominate. With leverage declining, house prices will stabilize. Then the private homebuilding market takes over, providing homes in the size—and with the amenities—that first-time buyers can afford. While price booms cannot be eliminated completely, the pain caused by bubbles and crashes is much less in a market where prime loans predominate.[7]

Even if private mortgage rates rose to the rates currently found on GES-guaranteed loans, and downpayments have been raised to at least 10 percent, it will be easier for first-time buyers to find a home they can afford because homebuilders will build them to be sold in that market.

[7] In July 2017, only about 57 percent of agency guaranteed home purchase loans had a risk rating of prime (an NMRI value of 6 percent or less). For the same month, only 2 percent of FHA insured loans had a risk rating of prime.