Testimony of Dr. Anthony B. Sanders
Before the House of Representatives Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Topic: "The Future of Housing Finance: The Role of Private Mortgage Insurance"

July 29, 2010

Mr. Chairman, and distinguished members of the Committee, my name is Dr. Anthony B. Sanders and I am the Distinguished Professor of Finance at George Mason University and a Senior Scholar at The Mercatus Center. It is an honor to testify before you today.

The Federal government purchases or insures over 90% of the residential mortgages originated in the United States. The proliferation of government programs for homeownership, purchase/insurance of low down payment loans by the GSEs and tax incentives for home ownerships were largely responsible for the housing bubble that occurred during the 2001-2006 period.[1] [See Figures 1 and 2] The problem is that public policy and risk management are intertwined resulting in bubbles and devastating bursts.[2][3] And the most vulnerable households are the ones most often hurt.[4]

The "Affordable Housing Crisis Cycle" must be broken. Even though trillions of dollars were pumped into the housing market during the last decade, homeownership rose from 67.8% in 2001, peaked at 69.0% in 2004 and declined down to 67.4% in 2009 – less than where they

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[1] See Figure 1 for the Case Shiller 10 City Index that demonstrates that house prices (as measured by the CS index) rose from 78.23 [Oct '96] to 226.17 [June 2006]. Not surprising after the GSEs added $8 trillion for housing finance over this time period.

[2] For a discussion of government intervention in the housing market, see Darrell Issa, "Unaffordable Housing and Political Kickbacks Rocked the American Economy," Harvard Journal of Law & Public Policy, Vol. 33. **www.harvard-jlpp.com/33-2/407.pdf**

[3] See Ed Pinto, "Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study." 2010.

[4] In 1988, I was quoted in the New York Times as advising against putting lower income households at risk of being financially damaged due to a declining housing market. Unfortunately, the government continues to encourage lower income households to own housing when renting is the more financially viable alternative. http://www.nytimes.com/1988/10/11/us/dukakis-in-levittown-offers-a-plan-to-help-young-families-buy-homes.html?pagewanted=2

started in 2001. [See Figure 3] The U.S. has comparable homeownership rates to other G7 countries, even though they do not have entities like Fannie Mae and Freddie Mac. [See Table 1] Given that there is a reasonable housing alternative in the form of renting (rather than owning), it is time to rethink the Crisis Cycle.[5]

We can break this cycle by getting private mortgage insurers and banks back in the game and down size government involvement in the housing finance area.[6]

The problem is that the Federal government offers explicit guarantees on residential mortgages which make it difficult for the private sector to compete.[7] This crowding out phenomenon is exacerbated by the raising of the loan limits after the stimulus for the three GSEs to $729,750 which effectively has crowded out the private insurance market. [See Figure 4]

My recommendations are as follows:

1. Fannie Mae, Freddie Mac and the FHA must downsize their market shares to open up the market to the private sector again. This can be done, in the short run, by curtailing the government purchase/insurance of low down payment loans and the lowering of loan limits down to pre-stimulus levels at first and then a gradual phase out of government insurance.

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[5] Raphael Bostic, a Senior Official at HUD, acknowledges that homeownership is not for everyone and the pursuit of homeownership rates is misguided. http://www.washingtonpost.com/wp-dyn/content/article/2010/07/20/AR2010072005946.html

[6] See Gerald Hanweck and Anthony B. Sanders, "Six Reasons Why Banks Aren't Lending to Business."

[7] Stuart Gabriel and Stuart Rosenthal found that the GSEs were responsive to HUD Affordable Housing Goals, but that the GSEs crowded out private lenders in that these loans were not held on bank balance sheets. See "HUD Purchase Goals and Crowd Out: Do the GSEs Expand the Supply of Mortgage Credit?"

2. Alternatives to Fannie Mae and Freddie Mac, such as covered bonds and improvements to private label securitization must be implemented.[8]
3. In order for capital to return to the market, it is necessary to restore confidence. The newly created Bureau of Consumer Financial Protection is generating significant uncertainty in the minds of investors as to how this Agency will function. Congress should pass clear guidelines and provide assurances that limit the reach of the new agency.
4. The long run structure of Fannie Mae and Freddie Mac must be resolved. However, true change is not possible if the Administration and Congress insist that there must be an explicit guarantee. I do not see any way that the explosive combination of public policy and prudent risk management can work. It failed in the housing bubble and crash and nothing has been done to prevent this from occurring over and over again.

Thank you for the opportunity to share my thoughts with you.

[8] See Andrew Davidson and Anthony B. Sanders, "Securitization After the Fall" for a discuss of recommendations to help return the securitization market.
http://merage.uci.edu/ResearchAndCenters/CRE/Resources/Documents/Davidson-Sanders.pdf

Figure 1. The Case Shiller Ten City Index.

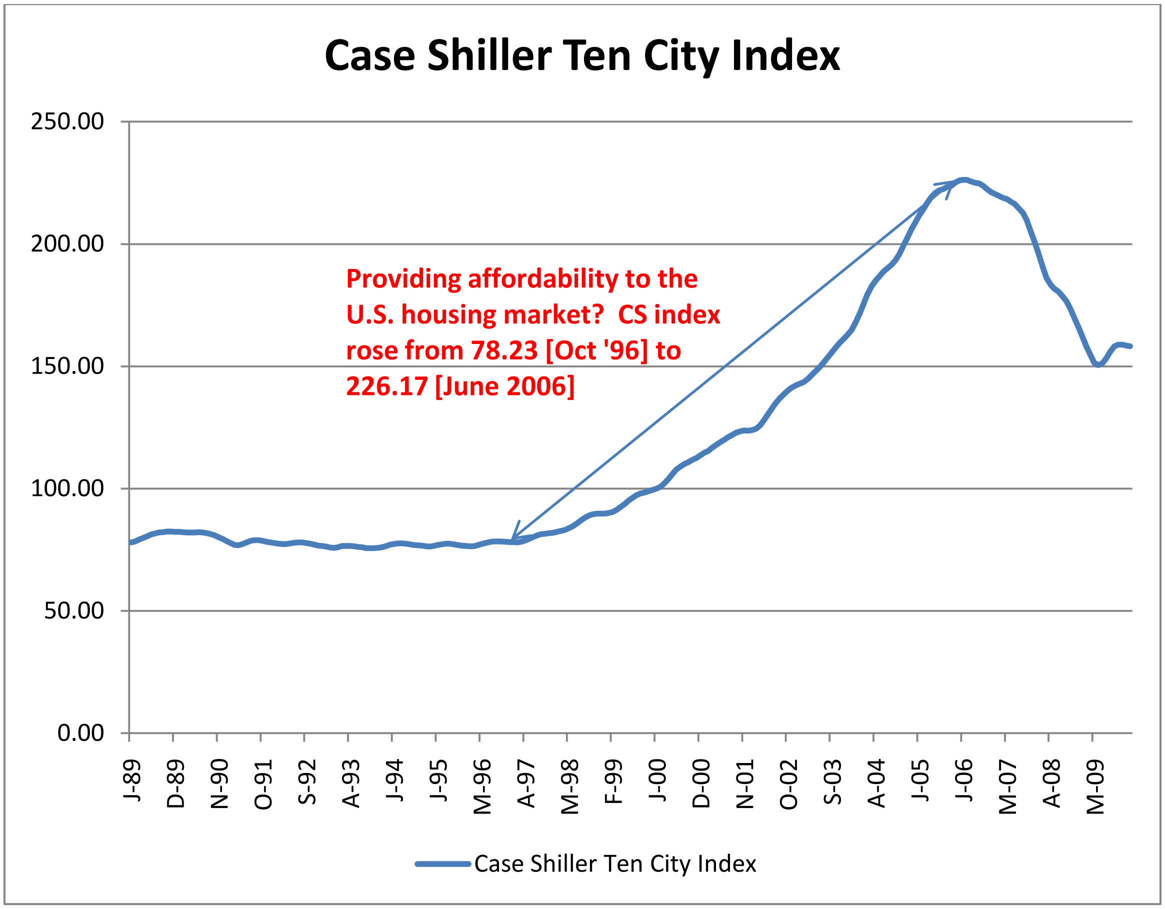
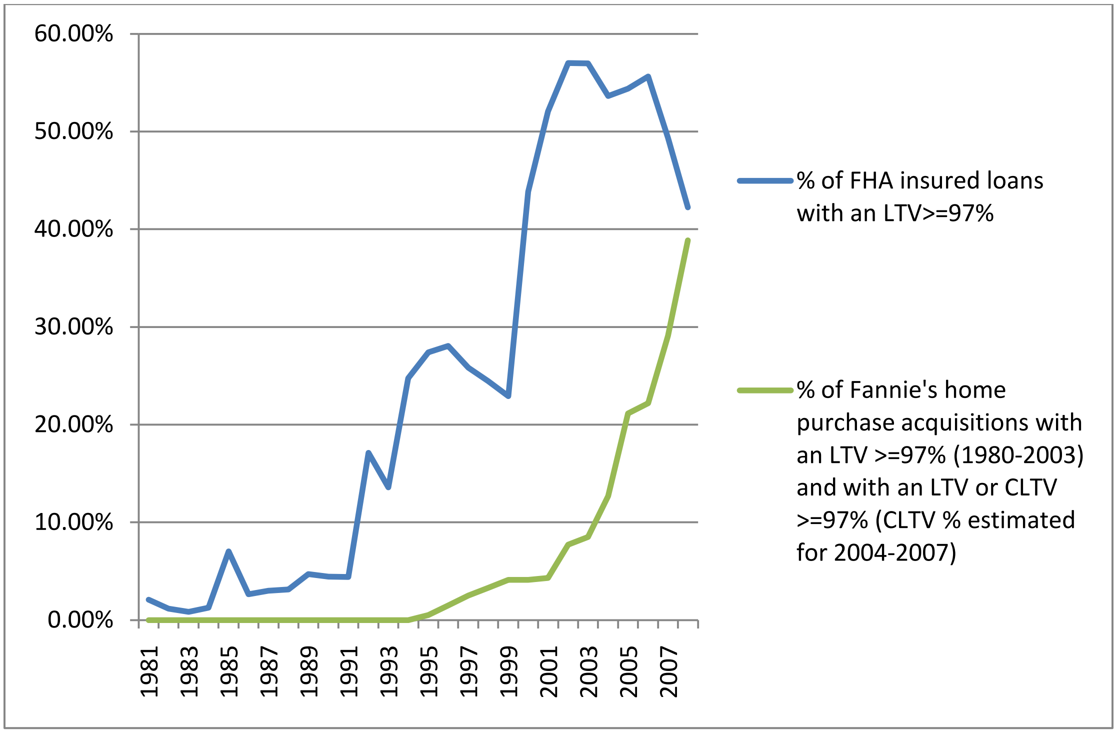
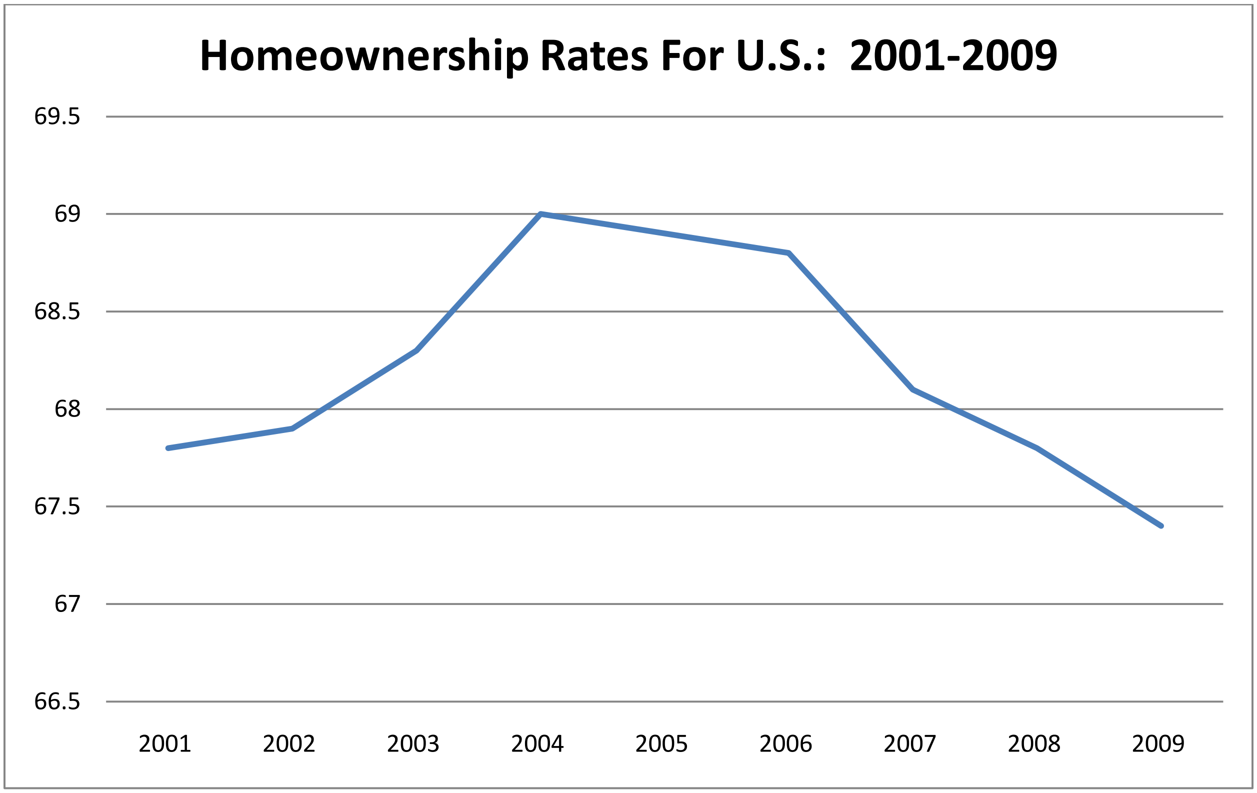


Figure 2. Low Down Payment Loans for FHA and Fannie Mae



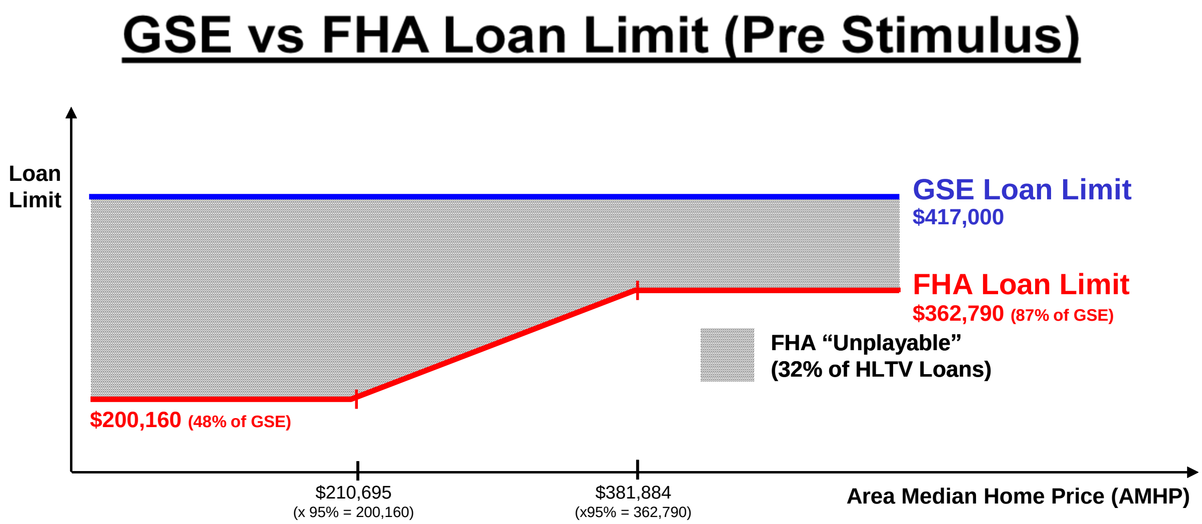
Source: Ed Pinto, "Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study." 2010.

Figure 3. Homeownership Rates for U.S. 2001-2009



Source: U.S. Census Bureau

Figure 4. GSE vs FHA Loan Limit: Pre Stimulus and Current



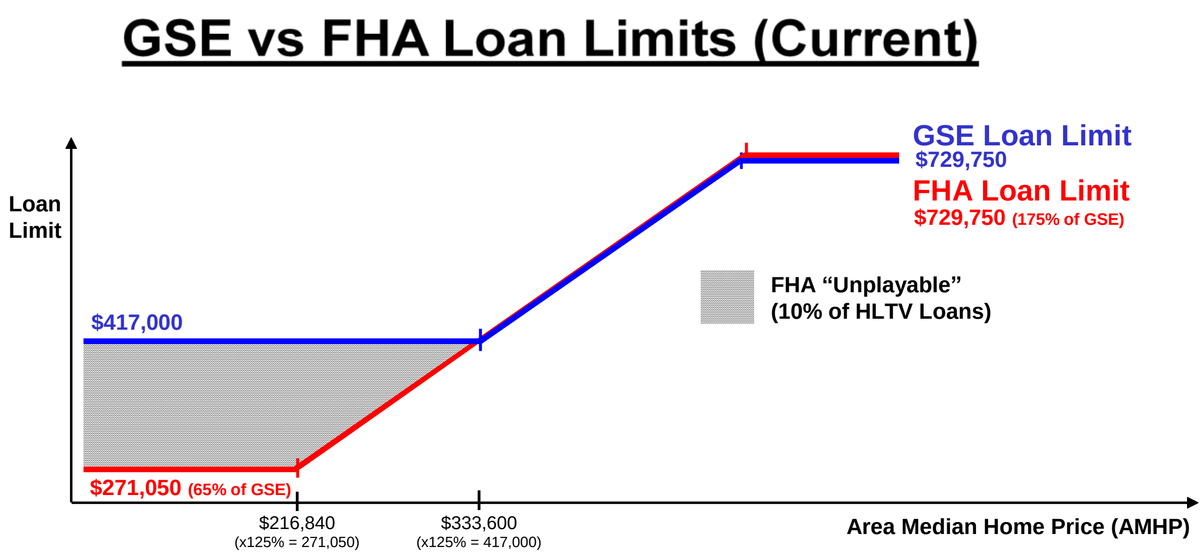


Table 1. Other (G-7) countries have similar home ownership rates without Fannie Mae and Freddie Mac

G-7 country	**2009 homeownership rate**
Italy	81.7%
United Kingdom	73.4%
Canada	68.7%
United States	**67.3%**
France	65.5%
Japan	61.2%
Germany	55.6%

Source: “Homeownership Rate Declines”, Wall Street Journal, February 3, 2010, p. A2