Reason

Testimony of Anthony Randazzo
Director of Economic Research
Reason Foundation

Before the Committee on Financial Services

U.S. House of Representatives

April 14, 2010

Chairman Frank, Ranking Member Bachus, and distinguished members of the committee, thank you for the invitation to testify today on the important matter of reforming our nation's framework for housing financing. My name is Anthony Randazzo, director of economic research at Reason Foundation, a non-profit think tank that researches the consequences of government policy, works to advance liberty, and develops ways the free market can be leveraged to improve the quality of life for all Americans.

The financial crisis has exacerbated the urgent need to reform Fannie Mae and Freddie Mac. These government-sponsored enterprises (GSEs) were important players in creating the housing bubble and bust that helped cause the recession and such great hardship for so many Americans. The GSE support of the housing market, backed by low interest rates from an implicit government guarantee, rapidly expanded the homeownership rate, which contributed to the spike in home values. Those prices turned out to be artificial and unsustainable

A fundamental overhaul of Fannie Mae and Freddie Mac is necessary before a real, sustainable recovery can take hold in the housing sector. Delaying reforms until there is a surge in housing prices or a new wave of housing starts allows the problems that caused the housing crisis to continue. And if Fannie Mae and Freddie Mac continue to distort mortgage prices and hinder a true long-term recovery in housing, we are laying the foundation for yet another housing bust.

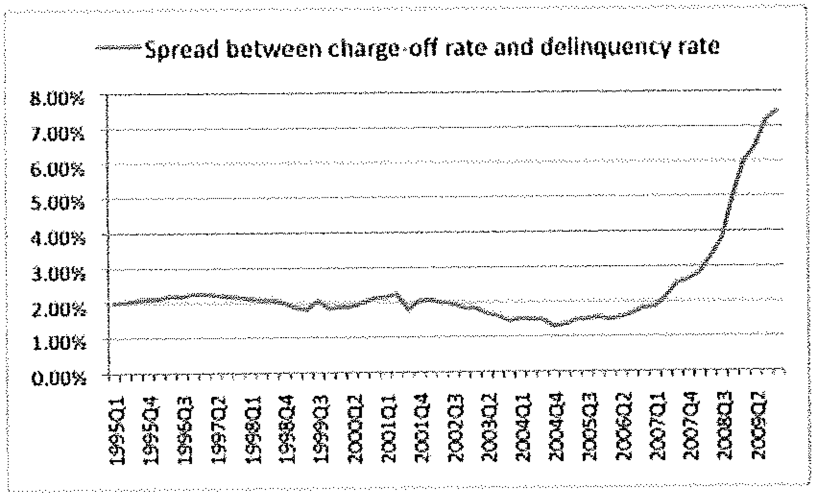
The Current State of the Housing Market

Negative Equity & Delinquencies: The growth in mortgage delinquencies is putting downward pressure on housing values, exacerbating mortgage losses in the financial sector, and contributing to the constriction in credit markets today. The massive amount of negative equity in the housing market today has pushed over 11 million homeowners into insolvency, putting a strain on the balance sheets of both banks and families. Currently, 25 to 30 percent of mortgages in America are underwater, meaning homeowners owe more on their mortgages than their homes are worth. The growing number of homes underwater has contributed to the spike in mortgage delinquencies. Over 14 percent of home mortgages were delinquent at the end of 2009. If delinquencies continue to rise at their current rate, there could be more than $300 billion in delinquent mortgages—up from around $250 billion today—by the summer.

The Shadow Inventory: With the growing delinquency rate has come more and more foreclosures. According to the Federal Reserve, 5.6 percent of mortgages are 90-days or more past due, the beginning stage of foreclosure. However, as bad as the foreclosure problem has been in some areas, it could be much worse. Banks have actually been slow to move many houses into foreclosure. Traditionally the bank charge-off rate of failed residential mortgages tracks relatively evenly with residential delinquencies. Yet, beginning in 2006 with the bursting of the housing bubble, the charge-off rate began to separate from delinquencies (see Figure 1).

Since 2005, the spread between the charge-off rate and delinquency rate has spiked over 500 percent. Banks are waiting to make these write-offs to avoid taking losses, or hoping that economic conditions will change and allow homeowners to get caught up with severely past due mortgages.

Figure 1: Spread between the charge-off and delinquency rates of residential mortgages



Source: Federal Reserve System

The foreclosures are also being put off due to moratoriums and other reasons. This group of mortgages—homes that are not being paid for, but are also not being foreclosed on—is contributing to a growing "shadow inventory" of homes. If these homes were on the market instead of being held in delinquency limbo, they would be adding downward pressure on prices by adding to the supply. Simply put, housing prices are higher than they otherwise would be right now because these homes are being kept off the market.

Federal Programs Promoting a Housing Recovery: Since 2007, there have been a number of programs to help promote a housing recovery. Current initiatives include the First-Time Homebuyer Tax Credit, the Making Home Affordable programs for modifying and refinancing mortgages, the mortgage-backed securities purchase program from the Federal Reserve, and the unlimited financial backing given to the GSEs. Unfortunately, these initiatives have not been successful at jump-starting a sustainable recovery in the housing sector.

In fact, the bailout of Fannie Mae and Freddie Mac has distorted the supply of money available for homes by providing more liquidity to housing than is really available in the private market. As a result prices are being kept artificially high.

The First-Time Homebuyer Tax Credit is not increasing the rate of homeownership, but is distorting housing prices. The temporary bump in residential investment in

2009 from homebuyers taking advantage of the tax credit was subsequently wiped out by a sharp fall in housing sales after the first deadline passed. The tax credit took future demand for housing and moved it to 2009, keeping prices from falling to their natural bottom, a step that is needed to ensure the long-term stability of the housing market.

The Making Home Affordable programs have good intentions, but they are aiding a select few while perpetuating a cycle of propping up prices, pretending they are stable, and then trying to clean up after the façade falls apart. Over 75 percent of trial modifications failed in 2009. And it is estimated that about 70 percent of approved modifications will eventually fail as well. This is just delaying, rather than solving, the problem of foreclosure. Financial institutions should certainly work with homeowners to adjust mortgages and keep families in their homes. But by delaying the foreclosure process with taxpayer money, the government is just increasing the shadow inventory and creating problems for housing prices in the future.

And finally, while the mortgage-backed securities purchase program operated by the Federal Reserve (like similar activities by the Treasury Department) has helped maintain mortgage prices for the past few months, this has come at a cost of artificially propping up prices. Not allowing housing to find its true bottom means that a recovery will be built on a false foundation, and we will likely suffer another cycle of boom and bust in housing.

Fannie Mae & Freddie Mac: The GSEs are virtually the sole source of liquidity in the mortgage market today. While this situation has propped up housing prices, it is mainly distorting mortgage interest rates by using a public subsidy to maintain low interest rates in the secondary mortgage market. Without the GSEs, mortgage prices would rise to market-based rates and housing prices would drop further.

However, as counterintuitive as it may seem, that would actually be *good* news. It would set the stage for an organic recovery—that is, a naturally evolving and sustainable recovery—as private lenders would once again become more willing to invest in a market comprised of assets with undistorted values. As a bonus, American taxpayers would no longer be subsidizing mortgages that will never be repaid while shouldering risks that belong on private entities.

Fannie Mae and Freddie Mac cannot be immediately eliminated because virtually the entire mortgage market is dependent on them as a wastebasket for toxic mortgage debt. But a strategy for dissolving Fannie Mae and Freddie Mac over the next few years can and should be created now. There are three main components to the process of phasing out Fannie Mae and Freddie Mac:

1. The first component involves divesting the mortgage portfolio and liabilities of the GSEs, winding down the purchasing and securitization operations, and liquefying all remaining assets. Ideally, this would be done over a four-to-five year process.

2. The second component is the GSEs's mortgage-backed security pools, a separate entity on the federal flow of funds balance sheet. These mortgage-backed securities pools represent all mortgages from the GSE portfolios that have been securitized and shifted off GSE balance sheets. These assets would need to be divested or shifted into a bad bank holding entity—preferably one serviced by a private sector asset manager—as Fannie Mae and Freddie Mac are phased out.

3. The third component is the GSEs affordable housing mission. Many of these activities should be re-evaluated now that it is clear they have done more harm than good. But in any case, programs intended to fulfill this mission could be shifted over time to the Federal Housing Administration, consolidating all such activities into one federal agency.

The Value of Reform Now Instead of Waiting

GSE reform is urgently needed. A plan should be put into motion this year, instead of waiting until 2011 or beyond. The sooner a plan that clearly outlines how Fannie Mae and Freddie Mac will be phased out is in place, the sooner the housing market can stabilize. The longer a plan is delayed, the harder it will be to shift towards a real recovery. When the rules of the new system are clear, the private sector will move into the shoes currently occupied by Fannie Mae and Freddie Mac. There are three primary reasons why waiting to reform the GSEs is a major problem and acting now would be of great benefit to the economy:

1. **Waiting increases risks to taxpayers.** The longer the GSEs are allowed to operate in their current role, as political rather than business entities, the greater the financial losses will be for taxpayers. The Treasury Department has already committed American taxpayers to covering all of Fannie Mae and Freddie Mac's financial losses. This financial risk should be borne by the private sector. Given the nation's exploding debt, it is imprudent to simply wait and let more losses build up. Acting now means helping taxpayers avoid the sustained losses from maintaining the GSE model backed by government guarantees.

2. **Waiting allows the recovery to be built on a faux-foundation while continuing the housing boom and bust cycle.** When it comes to finding a solution for the nation's housing ills, the focus should be on encouraging and fostering a *sustainable* recovery. Waiting to reform the GSEs would let an unsustainable *faux*-recovery build up in the system that will eventually come apart at the seams. Growing delinquency and home vacancy rates, the expanding shadow inventory, and negative equity troubles indicate an excess of supply that is only going to expand in the coming months. This means that at current prices, the quantity of homes available for sale is greater than the quantity demanded at current prices. Eventually that

shadow inventory will hit the market and expose the housing "recovery" as a façade.

Many people overpaid for their homes, especially if they bought in 2005 and 2006. This is a common feature of any bubble. Removing the government support of mortgage prices and allowing prices to adjust to their natural levels is a requirement for recovery. This will mean short-term pain, as the negative equity issue gets worse and foreclosures increase. But the long-term value is that the housing market will finally reach its organic level of prices, and future growth will be stable, avoiding another "boom-and-bust" cycle.

3. **Waiting perpetuates the feeling of uncertainty in the financial markets that has largely frozen capital.** The uncertainty that gripped the market in 2008 was the chief reason credit markets froze up, paralyzing the financial system. While inter-bank lending has returned, banks are largely holding onto their capital as a reserve against the potential of future problems. Waiting to reform the GSEs would keep lenders in perpetual limbo on what the future market for housing finance will look like. It is likely that capital that could be used for the mortgage markets, increasing lending availability, and pushing down mortgage prices (and thus increasing housing values) will remain frozen until the market knows what the new rules of the game are. Putting a plan in place to reform the GSEs would provide the private sector a roadmap for how and when it could replace Fannie Mae and Freddie Mac's role in the market. There remain other uncertainties in the market surrounding financial services regulation reform in general, but putting the GSEs on a defined phase out plan would be a very positive step in alleviating some of those concerns.

Principles of Reform

There are two overarching problems plaguing the housing industry today: uncertainty about the future and crippling price distortions that threaten to prevent a sustainable housing recovery. Any principles for reform must be focused on addressing these two issues.

- **We should reform now.**

The current policy of the Treasury Department, as Secretary Geithner testified before this Committee, is to wait until housing markets are more stable before reforming the GSEs. However, any such stability will be artificial and susceptible to sudden declines either from another bubble bursting or from the emergence of a large supply of the shadow inventory into the market.

A prudent first step would be to reduce conforming loan limits to restrict GSE operations in the "jumbo" markets. Conforming loan standards could also be reduced further to median home value levels on a state-by-state basis, or even to the affordable housing rates that municipalities develop (often a mortgage payment costing no more than 30 percent of a family's income). Another prudent step would be to immediately limit the time frame that GSEs are allowed to keep raw mortgages and securitized mortgages in their portfolios. These steps would not impact the GSEs affordable housing mission. Rather, if they were put in place over the next one to two years they would both protect taxpayers by reducing GSE lending activities while also phasing out the GSEs for the private sector to step in.

While the housing market is weak is precisely the time to act to reform the GSEs and promote innovation. With a long-term view of the market, it is imperative to fix the problems in housing today, dealing with short-term pains now instead of artificially covering them up and dragging them out over time.

- **We should create a future framework for mortgage financing that does not continue the "pro-cyclical" policies that support a boom-and-bust economy and distort prices.**

It is important for the housing market going forward to have a stable baseline for growth by knowing that price distortions have been removed and housing prices were allowed to reach their true bottom. In order for the mortgage and housing markets to be stable and for lenders to act more responsibly, perverse incentives must be removed from the system. The government programs created to artificially prop up housing prices during the recession should be closed and the mortgage-backed securities purchased by the Fed divested.

The First-time Homebuyer Tax Credit, currently set to expire in April 2010, should not be extended, nor re-engaged in the future. The initiatives under the Making Home Affordable Program—including HARP, HAMP, and 2MP—should be wound down quickly. Mortgages that have been refinanced or modified would remain so, and would remain managed under the agreed upon terms unless the homeowner again fell into default. All homes currently in a trial stage through one of the programs would be allowed to complete the procedures if passing all necessary tests. Congress should also encourage the Fed to begin divesting their MBS holdings as a part of a comprehensive exit strategy sooner rather than later.

Continuing these programs that avoid letting the market clear out the toxic debt delays the arrival of the bottom and prevents the natural recovery that would occur, which is likely to prompt another bust cycle based on artificially supported housing prices.

- **We should provide a framework for the private sector to step into the current role the GSEs have taken on in the market.**

A prudent process for gradually dissolving Fannie Mae and Freddie Mac will create opportunities for the private sector to step into the hole that will be left in the mortgage market. There is nothing the GSEs do for mortgage financing that would not be offered by the private sector, aside from implementing government policies that manipulate the housing market. The government should do all it can to create conditions that allow mortgage-financing innovation to thrive in the private sector.

One example would be the use of covered bonds, which are debt instruments collateralized by mortgages, where (unlike other MBSs) issuers are required to pay regardless of whether the collateral performs as expected. Covered bonds are widely used with great success in Europe and could potentially play a big role in creating a thriving housing market in the U.S. if the clear and sensible regulatory framework were to exist.

Another example would be restarting the securitization market. Some fear securitization, as it is seen as a catalyst for spreading around toxic debt. However, it was not securitization that was the problem, rather, it was the toxic mortgages in the first place. In the current market, and moving forward, investors have a greater incentive to analyze what assets are in their mortgage-backed security or collateralized debt obligation. Furthermore, as mortgages become harder to simply originate-and-distribute, the quality of mortgages will be higher. Securitization can return to its original purpose of increasing liquidity by only packaging healthy mortgages for informed investors. There should be new oversight rules for the securitization market that ensure transparency in what assets are packaged. Credit rating agencies laws should be altered in order to eliminate the perverse incentive in which the firm issuing the securities can shop for ratings by offering better prices to the credit rating agencies. And issuers of these types of securities could be required to maintain some stake in the performance of the investment vehicle if they themselves originated the loans packaged.

It is important to reiterate that Congress cannot engineer the exact means for how the private sector will engage the mortgage and secondary mortgage markets. Policymakers can implement some of the ideas out there right now, such as frameworks for covered bonds and securitization, but there may be other ways of providing liquidity and financing that haven't been used widely before, and that do not require government control or taxpayers bearing costs and risks. Congress should design rules and regulations to encourage private capital as the sole source of mortgage financing, avoid market-distorting policies, ensure transparency, and keep taxpayers from shouldering risk.

Conclusion

The past few decades have seen the housing sector distorted by government programs and policies. The result has been a "perpetuate and pretend" boom-and-bust cycle that must be abandoned. The limited demand for homes right now, even with programs aimed at stimulating the market, suggests that housing values are still inflated. The unfortunate reality is that housing prices likely need to fall even lower to reach their true bottom. In order for this to happen, the government must eliminate programs that are distorting the market. This will also help reduce the great uncertainty in the marketplace, which is necessary for the private sector to once again play the central role in helping Americans fulfill the dream of home ownership, in a sustainable manner.

Yes, if prices fall more, this will make the solvency problem worse in the near-term. Lenders will continue to struggle under the weight of their mortgage-related assets, in turn leading them to continue holding onto reserves in order to make the necessary write-offs, thus keeping credit tight for the country. However, delaying this problem will not make it go away. There are workable solutions to the housing sector mess, and they should be welcomed with a long-term perspective and acceptance of responsibility. When housing prices were rising through the early part of the decade until mid-2006, homeowners, lenders, politicians, and regulators were more than willing to accept the mythical gains in the housing market. Unfortunately those prices were artificial.

The policy response by the government to the drastic decline in prices has prevented, in the short term, homeowners and lenders from accepting the consequences of their bad investments. We have to recognize that, since home values were so overinflated, the new equilibrium will probably not push prices back up to those levels for some time.

The housing market must be permitted to find its natural bottom because that is the only real way to begin to fix it after years of distortion. Once the market is reformed—with the private sector providing both mortgage origination services and secondary market services—and with the private sector bearing full responsibility for private decisions, there will be less risk taken in the system than before. And perhaps most important, taxpayers will no longer have to fear a housing price bust from the façade of distorted prices crashing down. The reformed market won't look the same as today, and prices cannot be guaranteed, but the most important benefit will be a more stable foundation for growth, putting America on a path to a sustainable housing market.

Thank you for the opportunity to testify on this important subject. I look forward to answering any questions that you may have.