Statement before the House Committee on Budget
On "Restoring the Trust for All Generations"

Restoring the Trust for Homebuyers and Renters

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Chairman Price and Ranking Member Van Hollen, thank you for the opportunity to testify today.

The Committee's goal of Restoring the Trust for All Generations is to be applauded. We can all agree on the goal of fostering a Nation "where the greatest number of American dreams may be realized".[1] But, as the Committee has observed, it is regrettable that "government programs developed over the past eight decades to meet these worthy aims are now failing the very people they were intended to serve."[2]

My research has found the same to be true with respect to decades of ill-conceived housing programs. In most cases these policies increase housing demand but do little or nothing about supply. When supply is increased, it is requires layers of subsidies and leads to a host of unintended consequences. The result: higher home prices and rents, particularly for low-income and minority households, the very ones these programs profess to help.

Today's subsidy laden, government-centric housing finance system creates an "economics free zone", indifferent to supply and demand [It's Time to Put the Market Back in Housing Finance, Unaffordable Affordable Housing]. An alphabet soup of agencies has promoted a massive liberalization of mortgage credit backed by countless trillions of dollars in lending. At the same time, layers of subsidies combined with federal, state, and local regulations act to drive up costs while simultaneously constraining supply.

As a result housing has become less, not more affordable, and less, not more accessible. [How housing policies have made housing unaffordable]

Turning to the home loan market. Sixty years of affordable homeownership policies have failed to achieve two primary goals – increasing homeownership and achieving wealth accumulation for low- and middle-income homeowners. Today's homeownership rate of 62.9 percent is the same as in 1965 and we have not been unsuccessful at building wealth for the income groups these policies were aimed to help.[3] This is primarily been due to a reliance on low-down-payment, 30-year mortgages and other highly leveraged lending. These debt-based policies have driven up home prices faster than incomes, making homes less, not more, affordable.

The cause is straightforward. Just like the federal government, home buyers have become addicted to debt. Federal lending policies use highly levered debt to finance home buying by households with limited financial resources. This debt is used to finance a single asset—one that is highly illiquid and volatile with large transaction costs. High leverage means homeowners start with little equity and build

[1] Budget Committee, U.S. House of Representatives, 2015, Restoring the Trust for All Generations
[2] Ibid.
[3] Between 1989 and 2013, median wealth for households in the 40th to 60th percentile has decreased from $76,100 to $61,800, while median wealth for households in the 20th to 40th percentile has decreased by more than 50 percent, from $44,800 to $21,500.

additional equity very slowly, giving them little protection against both life's vicissitudes and volatile home prices. Even worse, debt-inflated prices are subject to great price volatility.

The 30-year loan is a relatively new phenomenon (not becoming commonplace until the late 1950s for Federal Housing Administration loans and the late 1960s to early 1970s for conventional loans). Low-down-payment loans are also relatively new.[4]

This can be demonstrated by comparing home financing in the mid-1950s to today. While the annual mortgage rate plus mortgage insurance premium is about the same—4.5%, financed homes have about doubled in size, and home prices have gone up much faster than incomes.[5]

This outcome requires increasing leverage and lots of it. Comparing FHA lending in 1954 to today:

- Loan terms have increased from 21 years to 29.5 years
- Down payments have decreased from 19 percent to 4 percent
- Housing debt-to-income ratios have increased from 16 percent to 28 percent

With home prices increasing faster than incomes, they became *less* affordable, moving the dream of sustainable homeownership and reliable wealth building further away for low- and moderate-income families. The government created debt-fueled wealth, not income-supported wealth, and the result was catastrophic.

This is because low-down-payment, slowly amortizing loans are prone to default. Before this expansion in leverage, the FHA's foreclosure start just about rounded to zero—yet the homeownership rate was at about today's level. Over the period 1975 to 2013, FHA homebuyers would suffer from 3.4 million foreclosures--one in eight such buyers. The entire market has experienced 11 to 12 million foreclosures over the same period, with low-income owners bearing the brunt of the impact.

We all know why this happens. Government involvement in housing finance sets in motion political pressures for increasingly risky lending, such as "affordable loans" to constituent groups. The liberalization of credit terms creates demand pressure that easily becomes capitalized into higher prices when undertaken in a seller's market. This is happening again today. The actual beneficiaries of these price inflating policies tend to be the government mortgage complex – real estate brokers, builders, building labor, the suppliers of building materials, speculators and community advocacy groups.

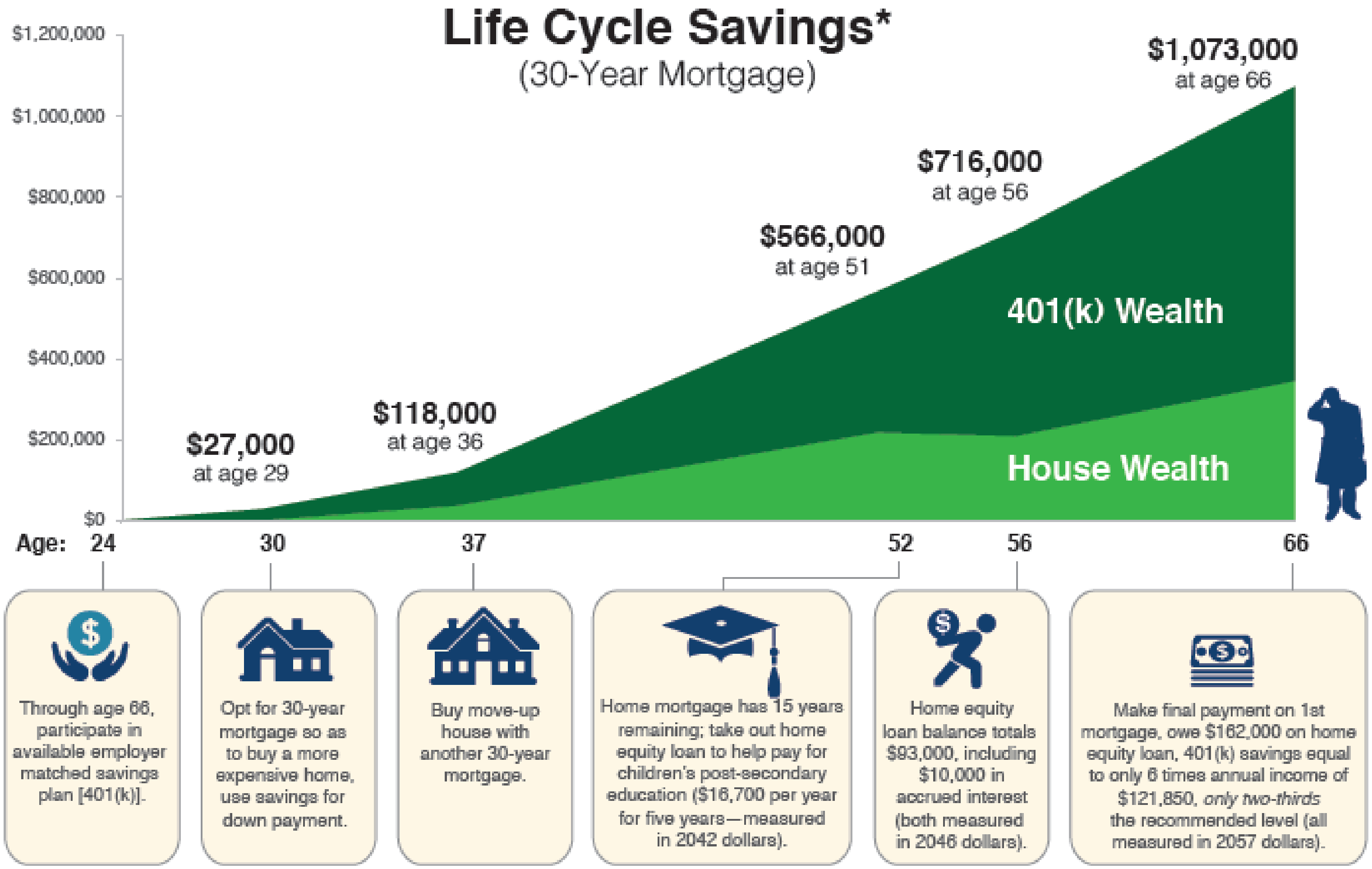
Equally troubling to this Committee should be the reliance of government loan policies on excessive household debt which crowds out the ability to save for one's retirement and pay for ones children's post-secondary education. Just like housing debt-to-income ratios mentioned earlier, total debt-to-income ratios (Total DTI) have also risen dramatically. Today, FHA homebuyers have an average Total DTI of 41 percent, with 1- in- 6 at 50 percent or above. We all know how this works—you are buying a home and told you can get approved for a loan of such-and-such amount based on income. These debt ratios are calculated on a pre-tax basis and the focus is on maximizing the amount of home you can buy.

[4] From 1946 to 1954, FHA loans averaged about 21 years; by 1960, they averaged about 28 years. Low-down-payment loans are also relatively new. From 1939-1954, FHA loans had an average loan-to-value ratio of about 80 percent. By 1966, FHA's average had risen to 93 percent. A similar upward trend occurred in the Veterans Administration and conventional markets.
[5] Inflation adjusted construction cost per square foot has stayed about the same.

No consideration is given to retirement savings or education expenses and the contributions these make towards wealth building.

Inadequate Life Cycle Savings where household starts own 401(k) contributions and employer match at age 24; uses 30-year mortgages for home purchase

Result: wealth build-up only two-thirds of that needed for comfortable retirement with substantial amount still owed on home mortgage, much of it used to finance children's education.

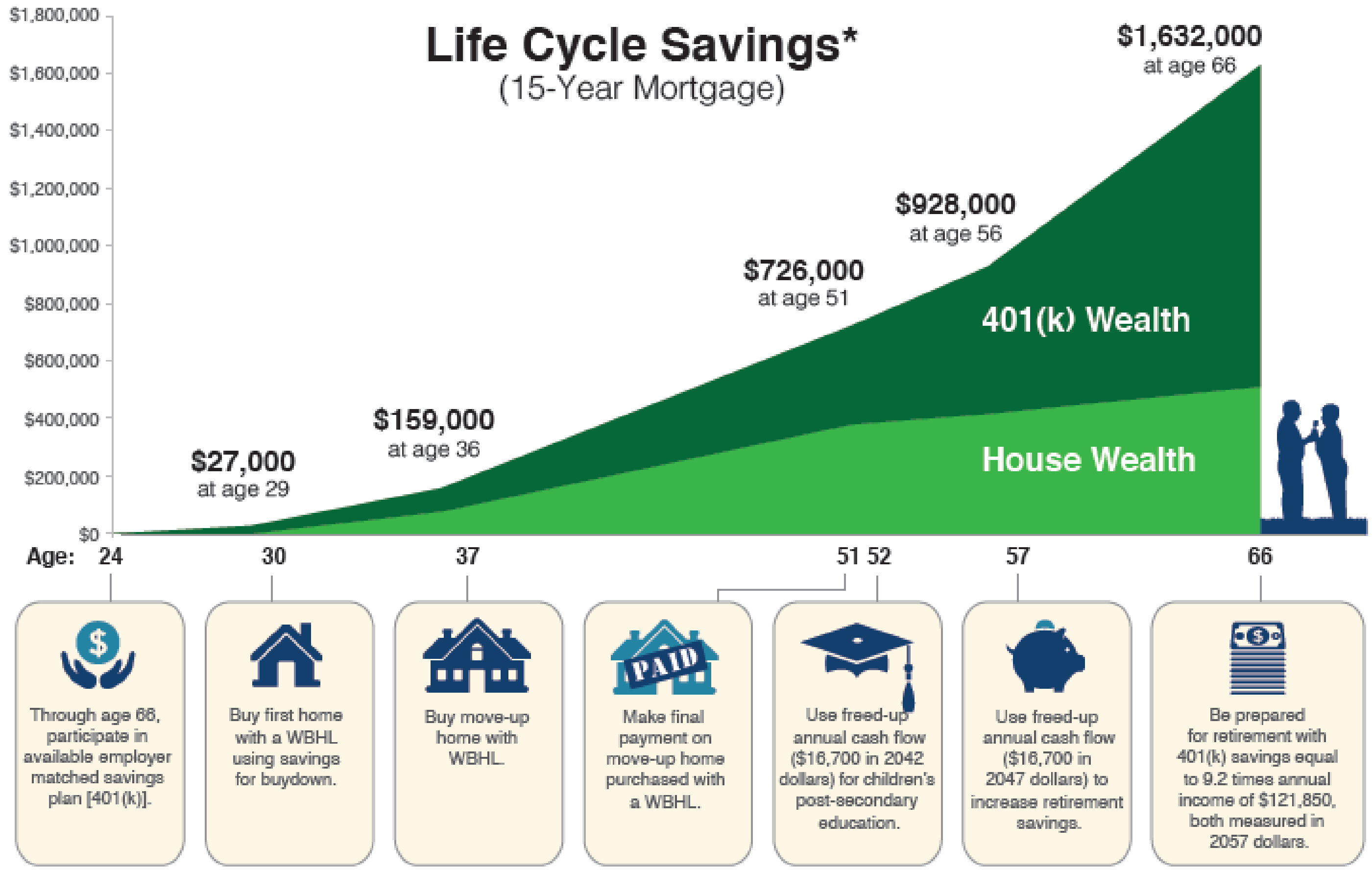


Infographic on wealth accumulation for a head of household starting at age 24 and has income at that age and beyond that is equal to the median US household income by the age of the household head. US Census Bureau data for 2013 household income by age of household head is used to estimate median household income in that year. This estimate is then adjusted for inflation of 2% to begin the simulation in 2014; the same inflation adjustment is applied to each subsequent year as the head of household ages. Home purchase at age 30 is financed with 30-year mortgage with 95% financing. House price is assumed to appreciate 2% per year, and expenses connected with the sale of the first home at age 36 equal 10% of sale price. For purchase of move-up home at age 37, borrower is assumed to take out a privately insured 30-year loan with a down payment of 13%; this down payment exhausts accumulated home equity on first home. Children's higher education expenses are assumed to begin at age 52 and continue through age 56. Since 30-year mortgage continues for 15 more years, home equity is tapped to pay for these education expenses. For the 401(k) calculation, the household head is assumed to contribute 4% of pre-tax earnings from age 26 through age 66, matched by a 4% employer contribution. At age 67, the household head is assumed to retire, at which point the 401(k) contributions end. 401(k) account balances are assumed to earn an annual return of 5.5% based on a review of retirement planning advisories published by Aon Hewitt (which uses a 7% return) and Fidelity (which uses 5.5%). In terms of how much accumulated savings (excluding home equity) are needed at retirement at age 67, Aon Hewitt and Fidelity recommend 9.4 and 8.7 times final pre-retirement salary respectively. All dollar amounts, ages and life events are illustrative only.

Wealth Building Life Cycle Savings where household starts own 401(k) contributions and employer match at age 24 and uses Wealth Building Home Loans for home purchase

This approach optimizes the combined wealth building capacities of defined contribution plans and home ownership

Result: a big boost in overall wealth-building ($1,632,000 and $1,073,000) by age 66. Household has adequate retirement savings, owns home free and clear, and paid parental portion of education expense.



*Infographic on wealth accumulation for a head of household who begins saving at age 24 and has income at that age and beyond that is equal to the median US household income by the age of the household head. US Census Bureau data for 2013 household income by age of household head is used to estimate median household income in that year. This estimate is then adjusted for inflation of 2% to begin the simulation in 2014; the same inflation adjustment is applied to each subsequent year as the head of household ages. Home purchase at age 30 is financed with a Wealth Building Home Loan (WBHL) with 100% financing and payment of 5 buydown points. House price is assumed to appreciate 2% per year, and expenses connected with the sale of the first home at age 36 equal 10% of sale price. For purchase of move-up home at age 37, borrower is assumed to take out a WBHL with a down payment of 23% and payment of 5 buydown points; these payments exhaust accumulated home equity on first home. The borrower pays off the WBHL on the move-up home at age 51. Children's higher education expenses are assumed to begin immediately after loan payoff and continue through age 56. All of the freed-up cash flow from the loan payoff is assumed to be used for these education expenses. For the 401(k) calculation, the household head is assumed to contribute 4% of pre-tax earnings from age 24 through age 56, matched by a 4% employer contribution. For ages 57-66, all of the freed-up cash flow from the loan payoff and the end of higher education expenses is assumed to be used to increase the 4% employee contribution to 13.7% of pre-tax earnings; the employer contribution remains at 4%. At age 67, the household head is assumed to retire, at which point the 401(k) contributions end. 401(k) account balances are assumed to earn an annual return of 5.5% based on a review of retirement planning advisories published by Aon Hewitt (which uses a 7% return) and Fidelity (which uses 5.5%). In terms of how much accumulated savings (excluding home equity and Social Security) are needed at retirement at age 67, Aon Hewitt and Fidelity recommend 9.4 and 8.7 times final pre-retirement salary respectively. All dollar amounts, ages and life events are illustrative only.

I try to keep these key facts in mind when developing policy solutions. First, wealth is the antidote for poverty. Second, wealth equals one's accumulated savings. Third, for fifty years government policies have ignored wealth building, and focused on income transfers. Fourth, the racial wealth gap is three times larger than the racial income gap[6]. Fifth, middle-income and working class families need a straight, broad highway to wealth building. Finally, while leverage can help, it must be used in moderation

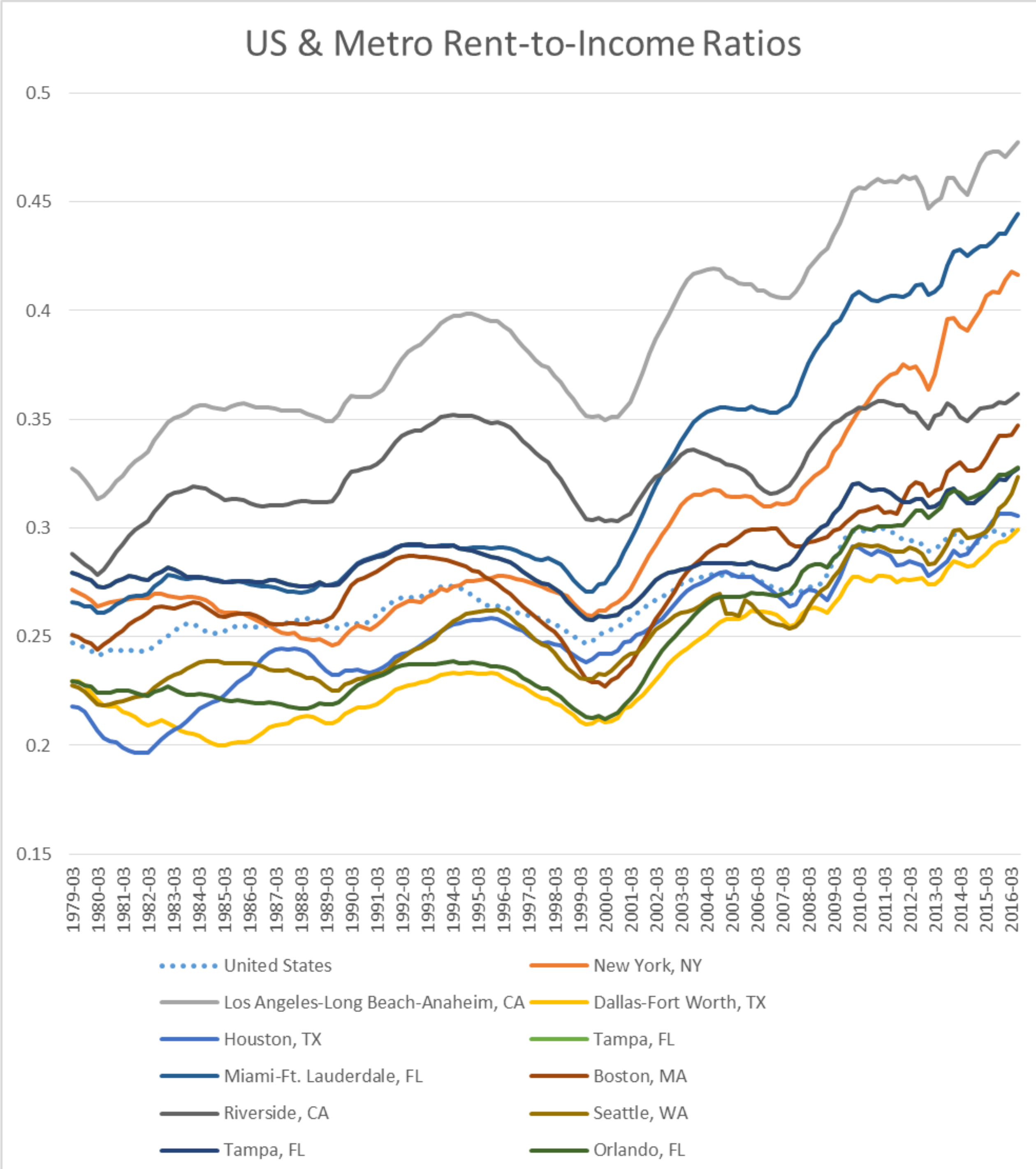
There is an alternative that takes all these into account. For most low- and middle-income families, the recipe for wealth building over a lifetime is to buy a home with a 15- or 20-year term mortgage that builds wealth rapidly [The Wealth Building Home Loan Builds Equity Fast], invest in a defined contribution retirement plan (ideally with an employer match) and use the freed up cash flow after the shorter term loan is paid off to invest in children's education and add to retire savings. Additionally, the home mortgage interest deduction should be restructured to provide a broad, straight path to debt-free homeownership. Today's tax code and underwriting polices work promote a lifetime of indebtedness by incentivizing homeowners to take out large loans for lengthy terms so as to maximize both the amount of home and the value of the deduction. Instead, both should be reoriented toward promoting reliable wealth building and debt extinguishment. Finally, my colleague Steve Oliner and I have developed *LIFT Home, the Low-Income, First-Time Homebuyer tax credit* designed specifically to build wealth. These steps would replace self-defeating affordable housing practices with policies capable of meeting the wealth building challenges of the 21st century. [It's Time to Put the Market Back in Housing Finance]

Turning to the rental market.

The case against current US multifamily housing policy is similar. There have been at least 42 major congressional enactments of Federal rental housing programs since 1932 (see Appendix A).[7] All promised to address pressing problems of the day. Consider the Housing Act of 1949 which set a national housing goal, to be realized as soon as feasible, "of a decent home and suitable living environment for every American family" or the Housing and Urban Development Act of 1968 which called for "implementation of a 10-year plan for the elimination of all substandard housing."

Yet, as this next chart demonstrates, rents have become increasingly <u>less</u> affordable, not more affordable:

[6] *Less than Equal: Racial Disparities in Wealth Accumulation*, Signe-Mary McKernan, Caroline Ratcliffe, Eugene Stanley, and Sisi Zhang, Urban Institute, April 2013.
[7] Sources: Edson, Affordable Housing— An Intimate History, 2010 and the Congressional Research Service, A Chronology of Housing Legislation and Selected Executive Actions, 1892-2003, https://www.gpo.gov/fdsys/pkg/CPRT-108HPRT92629/html/CPRT-108HPRT92629.htm



Federal, state, and local policies increase apartment construction costs. Eight of the 10 metros with the lowest multiples of 2015 median rent and median household income had less restrictive land-use regulations. Thirteen of the 15 metros with the highest multiples of 2015 median rent and median household income had more restrictive land-use regulations.[8]

[8] Demographia.com and author.

Multifamily debt (in 2010 dollars) is rising much faster than the number of total units because of liberal financing from Fannie Mae, Freddie Mac, FHA, and Ginnie Mae, as well as highly accommodative monetary policy.[9]

The numerous Congressional multifamily enactments over 84 years have failed the very people they were intended to serve. Yet, recently there has been a flurry of legislative proposals to add yet more housing subsidies to the housing sector, already one of the most heavily subsidized. For example, Senator Maria Cantwell (D-WA) and Senate Finance Committee Chairman Orrin Hatch (R-UT) introduced the Affordable Housing Credit Improvement Act of 2016 on July 14 of this year. This legislation would raise the cap on the Low Income Housing Tax Credit (LIHTC) allocation authority by 50 percent (to about $15 billion annually).[10]

There is an alternative. Market-based rental housing solutions are needed to bring rents back in line with median incomes and improve accessibility. Existing subsidized programs should shift to the "Blight Preventer" Loan. We need to shift from the current debt- and government-centric finance system to a rental housing market where supply is permitted and encouraged to meet demand. [It's Time to Put the Market Back in Housing Finance]

This quote from Milton Friedman appears on the Committee's website: "One of the greatest mistakes is to judge policies and programs by their intention rather than their result."

Let me conclude with a quote from the FHA in 1936:

"To many people, 'Mortgage' became just another word for trouble—an epitaph on the tombstone of their aspirations for home ownership."[11]

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[9] Paul Bubny, "CRE Debt Increase Hits 8-Year High (http://www.law.com/sites/paulbubny/2016/03/15/credebt-increase-hits-8-year-high/?slreturn=20160419120431)," Law.com, March 15, 2016.

[10] While the Low-Income Housing Tax Credit (LIHTC) is the primary means of promoting the construction of "affordable" apartments, it's expensive and opaque. New LIHTC credits currently total $10 billion annually, funding about 100,000 LIHTC units. These units have high construction costs (estimated $175,000 to $200,000 per unit). These units serve few low-income tenants; 80 percent are either extremely low income (area median income less than or equal to 30 percent) or very low income (area median income from 31 to 50 percent); only 7 percent have an area median income greater than 60 percent but less than or equal to 80 percent (Furman Center for Real Estate and Urban Policy. 2012. "What Can We Learn about the Low-Income Housing Tax Credit Program by Looking at the Tenants? (http://furmancenter.org/files/publications/LIHTC_Final_Policy_Brief_v2.pdf)" New York: New York University.). These units benefit from layers of subsidies, driving subsidy costs to $12,000 per unit, raising questions about unfair distribution of scarce resources. Subsidy layers include government-aided financing, state and local subsidies, and rental assistance (e.g., Section 8 and Housing Choice Vouchers) targeted to very low and extremely low income households.

The LIHTC program risks repeating the same errors as previous housing subsidy programs: (i) tenants are overwhelmingly minority households (61 percent), and nonelderly units are concentrated in metropolitan statistical area census tracts with high minority concentrations (Office of Policy Development and Research. 2016. Data on Tenants in LIHTC Units as of December 31, 2013 (https://www.huduser.gov/portal/sites/default/files/pdf/LIHTC-Tenants-2013.pdf), Washington, DC: US Department of Housing and Urban Development), and (iii) many developments face fiscal challenges to avoid blight that sets in after 16 to 20 years.

[11] Federal Housing Administration, "How to Have the Home You Want," 1936.

Appendix A: Federal rental housing programs enacted since 1932[12]

1932: Emergency Relief and Construction Act - the government's first major involvement in the housing field,

1933: National Industrial Recovery Act - Section 202 established the Public Works Administration which was authorized to build or finance public housing,

1934: National Housing Act established the FHA (including Section 207 Multifamily Insurance)

1934: National Housing Act authorized National Mortgage Associations (pursuant to this authority, the Federal National Mortgage Association was chartered on February 10, 1938, as a subsidiary of the Reconstruction Finance Corporation),

1937: United States Housing Act established Public Housing Authority,

1942: Section 608 authorized FHA mortgage insurance for rental housing for war workers,

1949: Housing Act – set national housing goal--realization as soon as feasible of the goal of a decent home and suitable living environment for every American family,

1949: Housing Act – Title I authorized Slum Clearance and Urban Redevelopment, also authorized a major expansion of public housing program including a shift to a focus on high-rise buildings,

1949: Housing Act – added Section 515 authorizing rural housing assistance,

1950: Housing Act amended Section 213 expanding cooperative housing mortgage insurance program, 1954: Housing Act added Section 220 for the prevention and rehabilitation of slums

1954: Housing Act added Section 221 to provide FHA mortgage insurance for low-cost housing for families displaced as the result of governmental action,

1959: Housing Act added Section 202 authorizing direct Federal loans for elderly rental housing,

1965: Housing and Urban Development Act added Section 23, a new program of rent supplement payments,

1966: Demonstration Cities and Metropolitan Development Act authorized Model Cities Program,

1968: Housing and Urban Development Act added Section 236 a new program of rental housing assistance for lower-income families,

1968: Housing and Urban Development Act created GNMA and FNMA as separate entities,

1968: Housing and Urban Development Act created Title IV--the New Communities Act,

1968: Housing and Urban Development Act created Title V which authorized the Urban Renewal Neighborhood Development Program,

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[12] Sources: Edson, Affordable Housing— An Intimate History, 2010 and the Congressional Research Service, A Chronology of Housing Legislation and Selected Executive Actions, 1892-2003, https://www.gpo.gov/fdsys/pkg/CPRT-108HPRT92629/html/CPRT-108HPRT92629.htm

1968: Housing and Urban Development Act created Title XVI--Housing Goals and Housing Reports (implementation of a 10-year plan for the elimination of all substandard housing and the realization of the 1949 national housing goal),

1968: Housing and Urban Development Act added new rural housing interest- reduction programs,

1969: Tax Reform Act added favored tax treatment for affordable housing projects,

1970: Emergency Home Finance Act authorized creation of Federal Home Loan Mortgage Corporation, 1970: Housing and Urban Development Act authorized Experimental Housing Allowance,

1970: Housing and Urban Development Act authorized Prevention of Housing Abandonment Programs,

1974: Housing and Community Development Act authorized Section 8 new construction and existing programs,

1974: Housing and Community Development Act created Community Development Block Grant program

1977: Housing and Community Development Act created Urban Development Action Grant Program,

1977: Housing and Community Development Act created Community Reinvestment Act,

1978: Housing and Community Development Amendments authorized Housing Assistance Programs providing further assistance (now known as the ``Flexible Subsidy'' program) for financially-troubled rental projects assisted by Sections 221(d)(3) or Section 236 mortgage-interest reduction programs or Rent Supplement payments,

1980: Housing and Community Development Act added a new Section 14 to the United States Housing Act of 1937 to provide a Comprehensive Improvement Assistance Program for existing public housing, 1983: Housing and Urban-Rural Recovery Act authorized experimental rental assistance in the form of a voucher,

1983: Housing and Urban-Rural Recovery Act established Rental Housing Rehabilitation and Development Grant Program,

1983: Housing and Urban-Rural Recovery Act authorized Housing Development Action Grant Program,

1986: Tax Reform Act authorized the Low Income Housing Tax Credit Program,

1987: Stewart B. McKinney Homeless Assistance Act,

1987: Housing and Community Development Act included Emergency Low Income Preservation Act, 1989: Financial Institutions Reform, Recovery, and Enforcement Act authorized Federal Home Loan Bank System Community Investment and Affordable Housing Programs,

1990: Cranston-Gonzalez National Affordable Housing Act enacted HOME Investment Partnerships Act, 1992: Federal Housing Enterprises Financial Safety and Soundness Act established GSE Affordable Housing Goals,

1994: Riegle Community Development and Regulatory Improvement Act established the Community Development Financial Institutions Fund, 2008: Housing and Economic Recovery Act establishes the Housing Trust Fund.

2008: Housing and Economic Recovery Act establishes the Housing Trust Fund.