TESTIMONY

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without Explicit Government Guarantees"
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Chairman Hensarling, Ranking Member Waters, and members of the Subcommittee: My name is Lawrence J. White. I am a Professor of Economics at the NYU Stern School of Business. During 1986-1989 I served as a Board Member of the Federal Home Loan Bank Board; in that capacity I was also one of the three Board Members of Freddie Mac. I have written extensively on the subject of the government-sponsored enterprises (GSEs) and on residential mortgage finance more generally; a chronological list of these writings is at the end of this statement, as is my short biographical summary and the "Truth in Testimony" disclosure form. I represent solely myself at this hearing.

Thank you for the opportunity to testify today on this important topic. Housing, and housing finance, continues to occupy an important place in the American policy conversation. Housing costs are a significant fraction – approximately 20% – of most families' budgets, and even more so for many lower-income households; and a family's residence is the environment in which the family members spend most of their hours in a week. It is therefore not surprising that public policy has shown a distinct bias toward subsidizing housing, often through subsidizing mortgage finance.[1]

However, along with the benefits of subsidy come costs; rarely are there "free lunches". The housing boom and bust of the decade of the 2000s and the financial crisis of 2008-2009, which was triggered by the housing bust, are fresh reminders of how costly such policies can be.

In the remainder of this Testimony I will outline the wide extent of government policies that encourage/subsidize housing construction and consumption, summarize their consequences – including an international comparison – and discuss a sensible way forward for housing policy and for residential mortgage finance in particular, which would involve reduced levels of subsidy for housing generally and less government involvement in housing finance.

Government policies that encourage housing production and consumption.

Government policies that encourage the construction and consumption of housing have been and continue to be widespread in the United States and occur at the federal, state, and local levels. Included (past and present) are:

- Income tax deductions for residential mortgage interest and for local property taxes;
- Government-sponsored enterprises (GSEs) that are focused on housing finance – primarily Fannie Mae and Freddie Mac, but also including the Federal Home Loan Bank System (FHLBS);[2]
- The Federal Housing Administration (FHA) and its mortgage insurance programs, as well as mortgage insurance that is provided by the U.S. Department of Veterans Affairs (VA) and the

[1] Another factor that surely encourages subsidy is the employment of millions of people by the tens of thousands of enterprises that are in housing construction and its related businesses.
[2] The FHLBS was created in 1932, primarily as a vehicle to provide low-cost wholesale funding to savings institutions, which in turn were expected to be housing lenders. After 1989, the FHLBS's mandate was broadened to community development, and its membership was broadened to encompass other categories of depository institutions, such as commercial banks and credit unions. For the remainder of this Testimony, unless otherwise indicated, my references to GSEs will mean Fannie Mae and/or Freddie Mac.

U.S. Department of Agriculture (USDA), and the Government National Mortgage Association (Ginnie Mae) to securitize these insured mortgages;

- A category of depository institutions (savings & loan associations) that were expected to specialize on residential mortgage finance;
- Subsidies for home builders;
- Subsidies for low-income renters; and
- Direct provision of rental housing ("public housing").

<u>The consequences</u>.

<u>a. Domestic consequences</u>. A basic tenet of economics is that if something is reduced in price (e.g., through a subsidy), people generally will buy more of it. Housing is no exception. As housing has been reduced in price through many of the programs that were outlined above, households have often bought "more house": They have bought larger and better appointed houses on larger lots.[3]

In turn, this "more house" (including more rental housing) has meant that more of the U.S. economy's resources have been devoted to housing and less to other investments that would have been more productive – such as business investments in plant, equipment, and inventories; government investments in schools, roads, bridges, hospitals, airports, etc.; and individuals' investments in more and better education and training. One set of studies from approximately 25 years ago estimated that the U.S. housing stock was 30% larger than it would otherwise have been in the absence of the widespread subsidies and that U.S. GDP was 10% smaller than it

[3] In addition to this "price effect", there has also been an "income effect", since U.S. households have generally had progressively higher incomes through the period since the Second World War.

would otherwise have been.[4] More recent studies have generally been supportive of these earlier findings.[5]

Further, much of these subsidies – especially those that are connected with home ownership – have tended to benefit upper-income households. This has especially been true for the mortgage interest and local property tax deductions, since upper-income households are more likely to itemize on their income tax returns (which is the only way that a household can take advantage of the deduction) and to buy (and finance) more expensive houses (which would mean larger deductions). The subsidies that are embedded in the GSEs' mortgage activities have tended to favor upper-income households as well, at least through the late 1990s.[6] And, more recently, even FHA activities have been more focused on upper-income households, as the limit on mortgages that the FHA could insure has been raised (starting in 2008) to $729,750 in high-housing-cost areas.

And, although increases in the rate of home ownership was an avowed goal of many presidential administrations, the subsidy programs tended to have, at best, only marginal effects on home ownership rates (and, of course, rental subsidy programs would tend to have the opposite effects). In essence, the subsidy programs tended to provide subsidies mostly for upper-income households who would likely buy anyway and thus who used the subsidy primarily to

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[4] See Edwin S. Mills, "Has the United States Overinvested in Housing?" AREUEA Journal, 15 (Spring 1987); and Edwin S. Mills, "Dividing Up the Investment Pie: Have We Overinvested in Housing?" Business Review, Federal Reserve Bank of Philadelphia, (March-April 1987).

[5] A summary of some of these more recent studies can be found in Viral V. Acharya, Matthew Richardson, and Stijn Van Nieuweburgh, Guaranteed to Fail: Fannie Mae, Freddie Mac and the Debacle of Mortgage Finance, Princeton University Press, 2011.

[6] See, for example, Jonathan Brown, "Reform of GSE Housing Goals," in Peter J. Wallison, ed., Serving Two Masters, Yet Out of Control: Fannie Mae and Freddie Mac, Washington, DC: AEI Press, 2001. The increase in the GSEs' conforming loan limit in 2008 for high-housing-cost areas to $729,750 (from $417,000) certainly expanded the GSEs' reach into upper-income housing areas. The maximum allowable amount was lowered in 2011 to $625,500, where it stands today.

borrow more – to leverage themselves more – than they otherwise would (since much of the subsidy came in the form lower-cost borrowing) and to buy "more house".

Another consequence has been the necessity for the U.S. Government to put Fannie Mae and Freddie Mac into conservatorships in September 2008 and to decide to honor all of the debt obligations of these GSEs; thus far, the required capital contributions by the Treasury to the GSEs have been approximately $188 billion.

b. International comparisons. Loose discussions of American housing policy have often claimed that these housing (and housing finance) policies have yielded superior outcomes, especially in comparison with the policies of other countries. The discussion above has shown some of the weaknesses in these claims with respect to superior outcomes. And the writings of Dwight Jaffee, Michael Lea, Alex Pollock, and others have shown that American housing outcomes have not been especially favorable in international comparisons.

For example, Table 1 reproduces data that were compiled by Alex Pollock that show that the U.S. does not rank especially high in an international comparison of home ownership rates, despite all of the subsidies described above (and much less emphasis on subsidizing housing in other countries).[7] Similarly, Table 2 reproduces data that have been compiled by Dwight Jaffee, which show that the U.S. ranks relatively unfavorably in an international comparison with 15 European countries as to the differential between the average interest rates that mortgage borrowers have paid and the average interest rates on short-term Treasury Bills of their

[7] However, as will be discussed below, a de-emphasis of the home ownership rate as a goal of public policy would serve the U.S. economy better for the future.

respective countries; Jaffee has also shown that the U.S. does not rank favorably in a number of other comparative measures.[8]

The way forward.

For overall housing policy, the most important policy measures would be cutbacks in the overall levels of subsidy for housing and for mortgage borrowing. A good place to start would be to phase out the income tax deduction for mortgage interest (and, along the way, convert it into a tax credit instead of a tax deduction), which would also have the benefit of improving the budgetary position of the federal government. Phasing out the GSEs and replacing them with a housing system that is largely privately supported, as is discussed below, would also be important.

Although there do appear to be modest societal benefits from the phenomenon of home ownership (which would justify a modest program to help low- and moderate-income first-time home buyers), the large-scale emphasis on the goal of expanding the rate of home ownership ought to become a relic of the past. Rental arrangements are appropriate for many households. After all, houses are large, risky assets that involve sizable transactions costs when buying and selling and that thereby impede geographic mobility; under most circumstances the financing of home ownership requires a steady income and budgetary discipline. Home ownership works for many households; but it is clearly not for everyone – especially when one remembers that housing prices do not always go up.

With respect to mortgage finance, approximately 90% of newly originated residential mortgages involve a federal government guarantee (through the GSEs, FHA, VA, or USDA) with respect to the credit risk on those mortgages. This historically very high percentage is the

[8] See Dwight M. Jaffee, "Reforming the U.S. Mortgage Market through Private Market Incentives," in Satya Thallam, ed., House of Cards: Reforming America's Housing Finance System, Mercatus Center, George Mason University, 2012.

consequence of the implosion of the housing markets after 2006 and the concurrent collapse of "private label" securitization, and the expansion of the GSEs and FHA to fill the financing void.

However, this absorption of 90% of the credit risk for residential mortgages by the federal government – and ultimately by taxpayers – is not a sensible long-run position for the federal government in a markets-oriented economy. Instead, residential mortgage financing should be primarily a private-sector activity; federal guarantees (and the subsidy that they carry) should be better targeted and should be restricted to helping (suitably screened) low- and moderate-income first-time home buyers obtain housing finance, through the FHA in on-budget, transparent subsidy programs.[9]

There are a number of questions and issues that are repeatedly raised in the context of a mortgage finance system that is largely devoid of government guarantees. One of the most prominent is whether the 30-year fixed-rate mortgage (FRM) would still be available to borrowers under a system of private finance. The answer to this question is a highly likely "yes". It is important to remember that 30-year FRMs were offered to borrowers for "jumbo" loans (i.e., for mortgages that exceed the GSEs' conforming loan limit) prior to the financial crisis and have continued to be available in the years since the financial crisis; this availability of 30-year FRMs – for all sizes of mortgages – should continue to be the case in a largely privatized mortgage market.

Further, 30-year FRMs pose interest-rate risks for investors, as compared with adjustable-rate mortgages (ARMs); but the federal guarantees cover only credit risk. *Consequently, for the issue of whether 30-year FRMs would continue to be available to borrowers (as compared with ARMs), the presence or absence of federal guarantees should be irrelevant.*

[9] This was Option #1 of the Obama Administration's "Reforming America's Housing Finance Market: A Report to Congress," February 11, 2011. In addition, over the longer run the subsidy programs should be transitioned from subsidies for borrowing (which encourage greater household leveraging) to down-payment assistance.

The interest-rate differential between jumbo loans and otherwise similar conforming loans prior to 2007 was approximately ¼ of a percentage point – a relatively modest amount. After the mortgage markets return to normalcy (see below), this differential could well represent the additional cost to borrowers from the absence of widespread government guarantees. Even if the differential were twice this size, the additional cost to borrowers would still be relatively modest.

A second widespread question is where the funding for the largely privatized mortgage market would come from. Partly the funding would come from depository institutions. As late as 2007, despite the competition from the GSEs and all of the advantages that the latter enjoyed, depositories held (as "whole loans" – i.e., not as mortgage-backed securities) 30% of outstanding mortgages. In the absence of the GSEs and their advantages, the depositories' share would likely increase. If covered bonds – bonds that represent a claim on a depository institution but that also have specific mortgages as collateral – become more prevalent in the U.S., this would be a factor that would likely help depositories enlarge their share yet further.

The remainder of mortgage financing would come through private-label securitization, which should revive if the advantages of the GSEs are curtailed and when the final rules with respect to "qualified residential mortgages" (QRMs) are promulgated. Given the failed experience of the 2000s, the securitization tranche structures would likely be simpler, with more information being provided to investors.[10]

Among the natural buyers of the senior, relatively safe tranches of the 30-year FRMs that would be securitized would be life insurance companies and pension funds – both of which have long-lived obligations that would be readily balanced by the long-lived assets of the 30-year FRMs. As of the first quarter of 2013, however, these two categories of financial institution held

[10] Also, bond insurers and/or the credit-default swap (CDS) market could help bond investors deal with the risks.

almost $16 trillion in assets but held only $764 billion in residential mortgage-backed securities (RMBS) – less than 5% of their assets. It appears that the heightened interest-rate risk that is embodied in the "free" prepayment option[11] that accompanies most 30-year FRMs has been a deterrent to these institutions' wider investment in RMBS. Consequently, suitable fees for the exercise of the pre-pay option are an important part of a largely private mortgage finance system. The higher-risk junior tranches would likely be bought by hedge funds and by high-risk bond mutual funds.

Additional policy measures that would help provide a more robust privately oriented mortgage financing system would include making lender recourse the norm for mortgage borrowing (which would reduce strategic defaults and reduce over-leveraging), as is the norm in many other countries, and giving the primary lender the power to approve whether the borrower can take out a second lien (which is the norm in commercial lending generally).

Conclusion.

The reform of housing policy generally – to end widespread subsidies for the construction and consumption of housing – and the reform of mortgage finance to allow a largely private-sector markets-oriented structure would be worthwhile policy actions for the U.S. economy. The sooner that such policy actions are taken, the sooner will the U.S. economy benefit.

Thank you again for the opportunity to testify at this important hearing. I would be happy to answer any questions from the Committee.

[11] However, although the exercise of the pre-payment option may be free to those choose to exercise it, the availability of this costly option adds about ½ percentage point to the interest costs on 30-year FRMs; see Jaffee, op. cit.

Table 1: An International Comparison of Home Ownership Rates in the 2000s

Rank	**Country**	**Ownership rate**
1	Singapore	89%
2	Spain	85%
3	Iceland	83%
4	Belgium	78%
5	Norway	77%
6	Portugal	76%
7	Luxembourg	75%
8	Ireland	75%
9	Chile	73%
10	Italy	72%
11	Israel	71%
12	Australia	70%
13	England	68%
14	Canada	68%
15	Sweden	68%
16	New Zealand	68%
17	**United States**	**67%**
18	Japan	61%
19	Finland	59%
20	Czech Republic	59%
21	France	57%
22	Netherlands	57%
23	Austria	56%
24	Denmark	54%
25	Germany	46%

Source: Alex J. Pollock, Testimony before the Subcommittee on Security and International Trade and Finance, Committee on Banking, Housing and Urban Affairs, U.S. Senate, September 29, 2010.

Table 2: An International Comparison of Average Interest-Rate Spreads between Mortgage Interest Rates and Three-Month Treasury Bills, 1998-2010

Rank	**Country**	**Spread**
1	Sweden	0.91%
2	United Kingdom	0.93%
3	Luxembourg	1.05%
4	Spain	1.08%
5	Finland	1.09%
6	Ireland	1.15%
7	Portugal	1.35%
8	Norway	1.44%
9	Italy	1.56%
10	Austria	1.79%
11	France	1.80%
12	Germany	2.05%
13	Netherlands	2.06%
14	**United States**	**2.26%**
15	Belgium	2.58%
16	Denmark	2.58%

Source: Dwight M. Jaffee, "Reforming the U.S. Mortgage Market through Private Market Incentives," in Satya Thallam, ed., House of Cards: Reforming America's Housing Finance System, Mercatus Center, George Mason University, 2012.

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