Statement of

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Before the House Financial Services Committee

United States House of Representatives

September 29, 2010

Hearing before US House of Representatives, Financial Services Committee – September 29, 2009

Submitted testimony by Edward Pinto.

Chairman Frank and Ranking Member Bachus, thank you for the opportunity to testify today. During my 36 year career I have been involved in virtually all aspects of housing finance, including the GSEs, affordable lending, mortgage insurance and the primary and secondary mortgage markets. During my five years at Fannie Mae, I was head of marketing (1984-1987) and executive vice president chief credit officer (1987 to 1989). Since leaving Fannie, I have been a consultant to the housing finance industry.

My purpose in testifying is to provide both advice and caution as you begin deliberations regarding the future of housing finance.

<u>Words of caution:</u>

John Adams observed 240 years ago: "Facts are stubborn things; and whatever may be our wishes, our inclinations, or the dictates of our passion, they cannot alter the state of facts and evidence."

Here are the stubborn facts that should convince you as policy makers of the dangers posed by repeating past government housing policy mistakes. Unfortunately even today some are counseling that your only choice is to do just that:

A. **A housing finance system built upon government guarantees poses an inherent risk to homeowners and taxpayers alike. Numerous proposals have been made that call for ongoing government support.[1] Against this chorus consider the advice of Paul Volcker, special adviser to U.S. President Barack Obama[2]:**

> **"The former Federal Reserve chairman said the mortgage industry is dysfunctional and a 'creature of the government' that needs reform…. he would want to avoid a 'hybrid' institution that is 'private when things are going well and public when things are going badly.'"**

[1] See footnote 7 to Peter Wallison, "Going Cold Turkey: Three Ways to End Fannie and Freddie without Slicing up the Taxpayers", American Enterprise Institute, September 2010 Financial Services Outlook, http://www.aei.org/docLib/FSO-2010-9-g.pdf

[2] "Obama aide Volcker says mortgage market reform crucial", September 22, 2010, http://www.foxbusiness.com/markets/markets/2010/09/22/obama-aide-volcker-says-mortgage-market-reform-crucial/

and Edward De Marco, acting director of the Federal Housing Finance Agency:[3]

> **"To put it simply, replacing the Enterprises' 'implicit' guarantee with an explicit one does not resolve all the shortcomings and inherent conflicts in that model, and it may produce its own problems."**

Director DeMarco went on to point out three risks: First, to assume the government would be better at pricing than the market is questionable. Second, this involvement could likely lead credit allocation and pricing distortions. Third, it could lead to misallocation of investment dollars.

B. A housing finance system designed around flexible and innovative underwriting standards in the pursuit of affordable housing goals presents a systemic risk to all homeowners and our economy. Consider the advice of FDIC Chair Sheila Bair:[4]

> **"First, we must recognize that the financial crisis was triggered by a reckless departure from tried and true, common-sense loan underwriting practices.**
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> **Traditional mortgage lending worked so well in the past because lenders required sizeable down payments, solid borrower credit histories, proper income documentation, and sufficient income to make regular payments at the fully-indexed rate of the loan."**

In an interview on Larry Kudlow's television program late last month Chairman Frank stated:[5]

> **"[i]t was a great mistake to push lower-income people into housing they couldn't afford and couldn't really handle once they had it."**

We had such common-sense practices in the early 1990s. These practices were slowly destroyed as a result of Congress' passage of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the "GSE Act") along with other policy initiatives.

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[3] Testimony of Edward DeMarco, acting director, Federal Housing Finance Agency, before the House Subcommittee on Caspital Markets, Insurance, and Government-Sponsored Enterprises, September 15, 2010
[4] Remarks by FDIC Chairman Sheila C. Bair to the Wharton School, University of Pennsylvania International Housing Finance Program; Philadelphia, Pa., June 18, 2010, http://www.fdic.gov/news/news/speeches/chairman/spjun1810.html
[5] http://www.gopusa.com/commentary/2010/08/kudlow-barney-frank-comes-home-to-the-facts.php

C. **Our housing policies have been deeply flawed. FDIC Chair Sheila Bair described it well:[6]**

> **"For 25 years federal policy has been primarily focused on promoting homeownership and promoting the availability of credit to home buyers."**

Appendix A contains a list of sixteen pro-cyclical policies that created the long and unsustainable boom in home prices and housing finance. I could find no counter-cyclical policies that were introduced over the same period. Also I could find no other developed nation that went to such policy excesses and none that have experienced our default levels. This alone should give you pause.

As a result of these policies Congress mandated the expenditure of many trillions of dollars that distorted the housing finance system and then spent trillions more to prop it up. To what end?

- **The collapse and bailout of Fannie and Freddie.**

- **Policies that boomeranged on the very homeowners these policies were ostensibly meant to help.**

- **A homeownership rate on the way back to where it was in the mid-1990s and which is lower than in many other developed countries[7], countries that did not spend trillions.**

Decades of mismanagement by Congress has placed our housing finance system on government life support. It is now clear that this interference has been both a failure and unnecessary.

Some have argued that federal intervention and guarantees are inevitable. Beware of such advice. The failures caused by past interventions are evidence that such intervention does not work. They will say - "but this time will be different." It will not – as Chairman Volcker noted any explicit government guaranty of private mortgages will once again privatize profits and socialize the inevitable losses. We

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[6] Supra. Bair

[7] A recent study completed by Alex Pollock found 16 developed countries with homeownership rates higher than the U.S. See testimony of Alex Pollock before the Subcommittee on Security and International Trade and Finance, Committee on Banking, Housing and Urban Affairs, United States Senate, September 29, 2010

can only be sure that the guaranty will be mispriced and taxpayers will be called upon to make good on it.

Stop micro-managing our housing finance system. Other countries allow for recourse lending, prepayment penalties, and other contractual provisions that help match risk and reward and keep defaults low.

<u>Words of advice:</u>

How should you proceed with getting our housing finance system off life support?

First and foremost have faith in the free market, which works best when Congress interferes least – consider how the free market provides an abundance of food and clothing, which like shelter are necessities of life. Thankfully congressional interference here is relatively minimal. Imagine going to Giant Foods only to find it run like the Postal Service.

Second, one cannot justify a continuation of flawed policies of government interference just because rates may go up. Rates go up and down all the time. Over my career mortgage rates have gone from 9% in 1974 to 18% in 1981 to near 4% today. This has had much less impact than the congressionally mandated abandonment of underwriting standards. Without the distortions inevitably created by government intervention, the market will price for credit risk. Adequate downpayments and capital requirements will assure sound underwriting and that bad business decisions are not bailed out by the taxpayers. As noted previously other developed countries do fine without such government guarantees. A recent comparative study of the Canadian and U.S. housing finance systems found that "when all of these factors are considered, it is hard not to conclude that Canadian fixed-term rates on prime mortgage loans are quite competitive with their U.S. counterparts."[8] Canada's homeownership rate is higher than the U.S.[9] It is worth noting the study's title: "Canadian Residential Mortgage Markets: Boring But Effective?"[10]

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[8] John Kiff, IMF Working Paper, "Canadian Residential Mortgage Markets: Boring But Effective?", June 2009, http://www.imf.org/external/pubs/ft/wp/2009/wp09130.pdf

[9] Supra. Pollock Pollock's testimony cautions that Canada has come to rely more and more on high LTV lending and house price increases now exceed those at the height of the U.S. bubble. He advises to stay tuned to see how this plays out.

[10] Supra. Kiff

A return to a privatized housing finance system:

Any return to a privatized housing finance system must be based on the following principles:

1. **Rather than putting additional trillions of tax payer dollars at risk, it is time to withdraw the government from having any role in financing prime mortgages and return to a system backed by private capital.**
2. **It is time to end the government's affordable housing mandates and allow the private sector to return to common sense underwriting standards.**
3. **It is time to return to an emphasis on thrift.**
4. **It is time to return FHA to its former role of serving the low income market, but with higher minimum downpayments so borrowers have more skin in the game.**

Options for the private financing of mortgages include:[11]

Once we return to the concept that prime loans should actually be low risk, many private market opportunities will present themselves. My purpose in laying out the few options below is to demonstrate that the private financing of mortgages is possible once we return to high quality loans that are prudently underwritten. As noted earlier we are the only developed country that interferes to such a great extent and, as a result we are only country experiencing sky high foreclosure rates and default losses:

1. **Private portfolio lending backed by private capital would continue to play a role.**
2. **Covered bonds should be examined as a financing option.**
3. **The Danish mortgage system presents possibilities.**
4. **Private mortgage backed securities issuances backed by mortgages meeting a rigorous regulator defined standard of "qualified residential mortgage" under Dodd-Frank is also feasible.**

Addressing Fannie and Freddie:

The feasibility of these private options is seriously in question as long as Fannie and Freddie are allowed to continue their history of market distortions. Congress should set a definite sunset date after which their charters expire. Their regulator should be given the authority to reduce their loans limits and portfolios so that they disappear by the end of the sunset period.

[11] Supra. Wallison and Pollock for details on these options.

Addressing the FHA:

Likewise, the feasibility of these private options is seriously in question if FHA is allowed to continue to insure such a large part of the market along with its policy of minimal downpayments.

1. **Raise the minimum FHA downpayment on home purchase loans to 5%-10%[12], with reduced seller concession amounts and tightening of other gimmicks that distort home values[13];**
2. **Limit FHA's volume of low downpayment loans to a 10% market share so as not to distort the housing market;**
3. **Reduce FHA's dollar limit back to a level commensurate with its low and moderate income housing mission; and**
4. **Require FHA lenders to have real skin in the game through a coinsurance requirement of perhaps 10%, backed by adequate capital requirements.**
5. **Homeowners without the requisite 5%-10% down would be encouraged to participate in a 5-year downpayment savings plan. Below is an example for saving 10%:**

   a. Establish a five year savings plan based on saving $25 - $35/week would be established. $6500 - $9100 would be saved over 5 years. Add in interest earnings at 3% and an employer match through a 401k or a foundation grant and the total grows to $15,000 - $20,000 at the end of 5 years, enough for a 10% downpayment on a home that sells for 80% of the median; and

   b. At the end of five years, the prospective homeowner has demonstrated thrift; having saved a substantial downpayment, set a goal and kept it, established a banking relationship and savings pattern, hopefully established a solid credit history and is now in a position to buy a home. The bank holding the saving plan account would be a suitable lender.

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[12] One idea would be to set a 23 year loan term on 95% LTV loans and a 30 year loan on 90% LTV loans. At the end of 5 years both loans would have about an 82% LTV (based on original sales price).

[11] A major goal of single family AH is wealth building through homeownership and equity build-up. Clearly past efforts have not worked out well for many, if not most AH borrowers.

The lack of significant equity by large numbers of borrowers in neighborhoods is both a major cause and a continuing contributor to housing price instability. Real estate is fundamentally cyclical and borrowers (particularly those of low and moderate income) need staying power in the form of equity, fixed interest rates, good credit habits, and debt ratios that allow for some cushion.

<u>Appendix A:</u>

The following is a list of pro-cyclical/pro-leverage policies that helped drive the long boom in home prices and housing finance. The first policy dates to 1986. There were no counter-cyclical policies introduced over the same period:

a. **Interest deductions under the income tax code were effectively limited to interest incurred on loans relating to primary and secondary residences in 1986. Aided by the home interest tax deduction, home mortgage debt as a percentage of GDP increased from 39% in 1986 to 50% in 1999 to 75% in 2007.**
b. **Mortgage interest rates continue their declines from the highs of the early 1980s. Rates decline from 10% in 1991 to about 5.5% in 2003-4. Fannie and Freddie grew each time rates dipped.**
c. **HUD's adoption of the National Homeownership Strategy and the Best Practices Initiative. These strategies relied on loosened loan standards in an effort to greatly boost the homeownership rate.**
d. **FHA continued its long-standing policy of progressively reducing down payments, continuing its role as market leader.**
e. **Capital requirements for the GSEs were effectively hard wired into the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (GSE Act). Capital levels were set at 222:1 for off-balance sheet and 40:1 for on-balance sheet assets – levels that the private sector were hard pressed to compete with. The GSEs also had the implicit guarantee of the federal government. This along with high leverage helped fuel their growth. As the GSEs' market share grew, spreads continued to narrow and the GSEs' competitors were crowded out. This forced their competitors to both move out the risk curve (for example, subprime) and to develop ways to increase their leverage levels (for example, CDOs and CDOs squared. Efforts to rein in the GSEs' charters during the boom period failed. Ironically partial charter reform occurred 2 months prior to their takeovers in September 2008.**
f. **GSEs' low- and moderate-income affordable housing mandates implemented by HUD pursuant to the GSE Act. HUD periodically increased the goals from 1993-2008, with most of these increases applicable to the low- and very low-income mandates. This forced the GSEs to greatly increase their subprime, Alt-A and low and no downpayment lending The regulations implementing the Community Reinvestment Act of 1977 (CRA) were amended in 1995 to provide for outcome based performance reviews and mandate the use of "flexible and innovative" underwriting standards. Both CRA and the GSEs' affordable housing goals allocated credit in a manner**

that largely operated independently of market conditions. They artificially created demand by increasing leverage through loosened lending. As a result of CRA and the GSEs' affordable housing goals, for the first time the GSEs and the private sector offered loans with 3% down (1994) and zero down (2000). The volume of these loans expanded rapidly over the period. Affordable housing and CRA mandates led to both the subsidization and mispricing of these higher risk loans.

g. **Risk-based-capital requirements implemented in 1988 heavily favored home mortgages and the GSEs' MBS and agency debt. By 2002 these advantages were extended to "AAA" and "AA" private MBS.**
h. **Loan loss reserving process was based on actual delinquencies. Low defaults during a boom period led to an accumulation of low levels of reserves at the point when the boom ends and defaults accelerate. This is compounded by the increased use of loan modifications. This masked the need for higher loss reserves.**
i. **In 1995 FDIC, due to the low level of bank failures then occurring, reduced the variable portion of deposit premiums to zero for "well-capitalized banks".**
j. **Loosened underwriting on investor loans on 1-4 unit properties. This was spurred in part by 1-4 unit rental affordable housing requirements implemented by HUD pursuant to the GSE Act.**
k. **An income tax law change in 1997 made speculating in homes a vocation for many homeowners. A married couple could live in a home for 2 years and pay zero tax on the first $500,000 of capital gain.**
l. **Loosened underwriting on cash out refinances. Higher prices promoted the wealth effect and reduced savings. This easy access to equity fueled the private spending boom – in downturn, the opposite happened.**
m. **Property valuations are based solely on a single input - comparable sales.**
n. **Nationalization of lending/underwriting/appraisal standards by the GSEs. In a market where the three most important things are location, location, location, the GSEs and their automated underwriting systems applied national standards regardless of local conditions.**
o. **The GSEs gave the best pricing and greatest flexibilities to the largest lenders. The top 10 lenders increase their market share from 25.8% in 1995 to 71.8% in 2007 (as reported by Inside Mortgage Finance).**
p. **By late 2003 and notwithstanding the lowest interest rates in over a generation, an affordability gap develops, as the house prices continued their unprecedented rise upward. This reinforced calls for additional loosened lending standards to eliminate or reduce the gap and effectively put CRA, affordable housing mandates and other loosened lending such as subprime and Alt-A on steroids.**

These policies induced an increase in demand, an expansion of lending, an increase in leverage, and increasing inflation adjusted and real home prices. Once the boom ended, many of these same policies served to reinforce the down-cycle.