To the Committee on Financial Services

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For Hearings On:

Reforming America's Housing Finance System

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Written Testimony of

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Mr. Chairman and Members of the Committee, I welcome the opportunity to discuss with you today the future role of our government in the U.S. mortgage market. There is now a widespread consensus that Fannie Mae and Freddie Mac should no longer operate as government sponsored enterprises (GSEs). It is thus timely to consider the best means for replacing the two GSEs.

Current discussions focus on two primary alternatives. The first would allow the private markets to replace the existing GSE functions. The second would create a government successor to the GSEs to continue to provide government guarantees against borrower default losses.

My research leads me to a strong endorsement of the private markets as the preferred alternative for two reasons. First, there is strong evidence that the private markets would operate at a standard substantially higher than that actually experienced under the GSE regime. Second, experience indicates that a new government mortgage guarantee program would again leave taxpayers at high risk, while creating little or no sustainable increase in American home ownership. I do believe, however, that there is a valid role for the FHA and VA programs, operating in their traditional manner with precisely defined programs, to provide benefits to lower income households and armed forces veterans.

The evidence that private markets can and should replace the GSEs comes in two parts. The first is U.S. experience itself. Making new mortgages—mortgage origination—has always been 100% a private market activity. Similarly, banks and other private investors have always owned the vast majority of U.S. mortgages and mortgage-backed securities (MBS). GSE portfolio holdings of mortgages and MBS rarely reached even 20% of the total.

Guarantees of mortgage backed securities is the quantitatively most important GSE activity. But even here, only once (in 2003), did the total of GSE portfolio holdings and guaranteed MBS reach 50% of total outstanding home mortgages. Prior to 1990 this total GSE share was always below 30% and prior to 1980 it was always a single-digit percentage. It is also worth remembering:

1) The GSEs did not invent mortgage-backed securities—that honor goes to GNMA, an agency within HUD.
2) All the innovations in asset-backed securitization, including prime jumbo MBS and commercial mortgage MBSs, were fully developed in the private sector. Indeed, during the 1990s, jumbo mortgage originations, which by definition exclude GSE participation, averaged over 20 percent of all mortgage originations. In 2000, jumbo mortgage originations reached 25 percent of all mortgage originations.

The conclusion is clear: the private markets are fully capable of efficiently carrying out all of the GSE mortgage investment and securitization activities.

This conclusion is reinforced by data that show the limited contribution the GSEs have made to expanding U.S. homeownership rates. Between 1950 and 1990, a period in which private markets dominated the U.S. mortgage markets, the U.S. homeownership rate rose from 55% to 64%, a notable achievement. Since 1990, the 23 year period of the most extensive GSE operations, the homeownership rate has been basically flat—today it is 65%, one point higher than the 1990 value of 64%.

Not to be deterred, the advocates for continuing government guarantees in the U.S. mortgage market often point to the 30-year, fixed-rate, mortgage as a major benefit of the GSEs. This is plain wrong for two reasons. First, the long-term, fixed-rate, mortgage was actually popularized in the U.S. by the Home Owners Loan Corporation during the Great Depression, long before the GSEs existed. Second, the GSEs have always pushed 100% of the interest rate risk embedded in fixed-rate mortgages onto the private sector investors that purchase their MBS and bonds. The willingness of U.S. private sector investors to hold long-term, fixed-rate, mortgages and mortgage securities is thus independent of the GSEs.

Given the limited contribution of the GSEs to the U.S. mortgage market, it is reasonable to ask why they were often held in high esteem, at least until their collapse in 2008. The answer is simple: by promoting the concept of an implicit government guarantee, the GSEs garnered a subsidy of approximately one-half of 1 percent point on their funding costs, i.e. 50 basis points. The GSEs then passed approximately one-half of this subsidy, i.e. 25 basis points, to mortgage borrowers on their conforming mortgages. There was simply no way private markets could compete with such highly subsidized GSE mortgages. This is crowding out 101. The remarkable fact is that, nevertheless, the private markets efficiently served jumbo mortgage borrowers with a mortgage rate that was actually below the GSE mortgage rate after netting out the GSE subsidies.

Turning to current conditions, the subsidies currently provided the GSEs are even more extreme: their securities are explicitly guaranteed by the U.S. Treasury, and the Federal Reserve purchases their securities as part of its Quantitative Easing. The GSEs, together with the FHA and VA programs, now guarantee about 90% of all new U.S. mortgages. Again, this is no surprise—it is just crowding out on steroids. Nevertheless, the private markets continue to originate jumbo mortgages, and their volumes have been rapidly rising since Congress reduced the GSE conforming limits and the GSEs are now required to charge guarantee fees closer to market levels. Indeed, this approach—lower confirming loan limits and raising GSE guarantee fees--provides a transition path forward to a well-functioning, private, mortgage market for the U.S. My recent Op-Ed in the American Banker, with Mark Willis, provides further details.

My research has also identified a second set of evidence confirming that private markets will outperform the GSEs in providing mortgage finance for homeownership. This evidence comes from Western European countries. European Union rules prohibit member states from creating entities such as the U.S. GSEs, since the subsidies are considered an unfair trade advantage. A comparison of these EU countries with the U.S. thus provides another test of the GSE impact. The results show the European countries outperforming the U.S. on virtually every measure of housing and mortgage market performance. Perhaps the most stunning result is that the U.S. home ownership rate equals only the average of 15 major Western European countries. The European housing and mortgage markets have also been substantially more stable than those in the U.S. Of course, house prices have recently declined sharply in countries such as Greece, Ireland, and Spain, but this is a failure of their macroeconomic budget policies, not their mortgage markets. Indeed, even with their crisis conditions, the mortgage default rates in these countries remain far lower than the recent U.S. experience. I am attaching, as an appendix, a table from my research that provides more details.

In closing, I turn briefly to my final reason for advocating private mortgage markets for the U.S., namely that, in my view, new government mortgage guarantee programs will inevitably fail because they will create the same taxpayer costs as the GSEs, just under a new name. To be clear, I recognize that many advocates of these programs ask for the government to provide only a catastrophe backstop, and they propose that the government charge appropriate fees for the guarantees it provides. This is acceptable in principle, and the current U.S. government terrorism insurance program—TRIA—could be seen as a prototype. However, in my view, the more realistic comparison is to the National Flood Insurance Program. This program also began with the best of intentions, with no intended subsidies, but in reality it provides large subsidies and especially to the very homes that are at the greatest risk of flooding. The result has been both a financial catastrophe for U.S. taxpayers and a human tragedy for those households for whom the National Flood Insurance Program creates subsidizes to place themselves in harm's way.

The bottom line is that no mechanism exists through which the U.S. government can effectively provide mortgage subsidies to most U.S. households. After all, almost all U.S. homeowners are also taxpayers. A subsidy then simply transfers money from a household's taxpayer pocket to its homeowner pocket. At best, this achieves nothing. While in reality it creates a misallocation in which funds that could create productive investments and job opportunities are diverted instead to the profit of third parties such as the GSEs.

Appendix

Table1: The Performance of European Mortgage Markets in Comparison with the US, 1998 to 2010

	(1)	(2)	(3)	(4)		(6)
	Rate of Owner Occupancy Latest Year	Coefficient of Covariation Housing Starts (2)	Standard Deviation of House Price Inflation	Mortgage Interest Rate Average Level	Mortgage Interest Rate Average Spread (3)	Mortgage To GDP Ratio 2010
Western Europe						
Austria	57.5%	7.2%	2.7%	4.83%	1.79%	28.0%
Belgium	78.0%	15.2%	7.4%	5.61%	2.58%	46.3%
Denmark	53.6%	56.1%	8.5%	5.80%	2.58%	101.4%
Finland	59.0%	11.9%	3.8%	4.13%	1.09%	42.3%
France	57.8%	17.4%	6.2%	4.83%	1.80%	41.2%
Germany	43.2%	29.0%	1.7%	5.07%	2.05%	46.5%
Ireland	74.5%	99.2%	14.2%	4.32%	1.15%	87.1%
Italy	80.0%	25.7%	3.4%	4.70%	1.56%	22.7%
Luxembourg	70.4%	17.9%	4.7%	4.08%	1.05%	44.7%
Netherlands	55.5%	14.5%	6.5%	5.08%	2.06%	107.1%
Norway	85.0%	24.6%	5.0%	6.11%	1.44%	70.3%
Portugal	74.6%	35.5%	2.9%	4.43%	1.35%	66.3%
Spain	85.0%	93.0%	8.1%	4.16%	1.08%	64.0%
Sweden	66.0%	45.5%	2.9%	3.75%	0.91%	81.8%
United Kingdom	66.4%	25.0%	6.8%	5.12%	0.93%	85.0%
EU Average	**67.1%**	**34.5%**	**5.6%**	**4.80%**	**1.56%**	**62.3%**
US	**66.9%**	**45.5%**	**7.3%**	**5.07%**	**2.26%**	**76.5%**
US Rank	**8th of 16**	**3rd of 16**	**5th of 16**	**6th of 16**	**3rd of 16**	**6th of 16**

Source: Dwight M. Jaffee, "Reforming the U.S. Mortgage Market Through Private Market Incentives, published in House of Cards: Reforming America's Housing Finance System, Mercatus Center, March 2012 available at http://mercatus.org/sites/default/files/House_of_Cards_March_2012.pdf