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"The Future of Housing Finance – A Review of Proposals to Address Market Structure and Transition"

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Chairman Frank, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to testify on the important topic of the future of housing finance. I am the Managing Director of the non-profit think tank e21: Economic Policies for the 21st Century (a.k.a Economics21). We aim to advance free enterprise, fiscal discipline, economic growth, and the rule of law. Drawing on the expertise of practitioners, policymakers, and academics, our mission is to help foster a spirited debate about the way forward for democratic capitalism. We are supportive of free markets while recognizing the need to devise and implement a reasonable structure of law and regulation that will help ensure our markets avoid catastrophic events in the future. We are therefore focused on developing policies that advance market performance and implementing rules to prevent market malfunction.

Previously, I was Special Assistant for Domestic Policy to President George W. Bush. In this role, I helped guide the collaborative process within the Executive Branch to develop and implement policies, legislation, and regulations across numerous agencies, including the Departments of Treasury and Housing and Urban Development.

Over the last year, a consensus has started to emerge that the main goal in addressing housing finance reform should be to promote the efficient allocation of credit to financing single-family and multi-family housing. Fundamental to this objective is a restructuring of our housing finance system, which includes resolving the conservatorships of the Government Sponsored Enterprises (GSEs) and rationalizing all of the other ways the government subsidizes housing.

As the financial and housing markets are still fragile, a top priority in this process must be an orderly transition. Already, Congress has taken important steps to address certain aspects of the mortgage market through the Dodd-Frank legislation. Important provisions include, credit risk retention requirements, minimum standards on a borrower's ability to repay, and limits on the ways loan originators can be compensated. How these provisions, along with others, are implemented through regulation in the coming months has important implications for the future of housing finance and the GSEs.

Today, I will focus on:

1. **Principles for a transition.**
2. **Rationalizing and streamlining federal housing programs.**
3. **Short-term and long-term drivers of reform.**

1. Principles for a transition[1]

a) Private capital should be the bedrock of our new mortgage finance system. It should have a role at every stage of the process, from primary origination to the secondary market to the application of insurance.[2] Having private capital at risk adds market discipline and keeps the incentives aligned for investors, taxpayers, and mortgage borrowers. While many have argued that only a government guarantee can attract the capital necessary for a liquid housing market through all economic cycles, I believe it is too early in this debate to close off other options.

b) Costs and benefits (subsidies) should be transparent, credible, and comparable. Everything should be on-budget, where it's easy for legislators and taxpayers to review. A particular focus should be paid to accurately accounting for contingent liabilities.

c) Renters should treated be more equitably compared with homeowners. This does not necessarily mean that renters should necessarily get more subsidies, but rather that the societal benefits of homeownership have been inflated over time, compared with renting.

d) Any future housing-related subsidies should be directed to homeowners with as few middlemen as possible. Subsidies should also be recalibrated to encourage equity, not more consumer debt, as leverage levels are still too high for both households and financial institutions.[3]

e) Ensure all institutions providing mortgage finance are adequately capitalized. The GSEs clearly did not operate with enough capital to buffer the risks they assumed, but much of the rest of the industry – from banks, to mortgage insurers, to shadow banks like structured investment vehicles – also operated with inadequate capital.[4] Policymakers should recognize that bailouts in the housing sector are inevitable if the key institutions in the space do not hold sufficient capital.

[1] This is not meant to be an exhaustive list. Having reviewed the testimony from previous hearings before this committee on the future of housing finance, I wanted to call particular attention to these principles.

[2] An underreported statistic through this housing crisis is that the mortgage insurance (MI) industry expects to pay around $30 billion in claims (in front of the taxpayer) to Fannie and Freddie.

[3] Before 2007, federal policy encouraged prospective borrowers to use second liens over other forms of credit enhancement, like private mortgage insurance, since only the interest paid on a piggyback loan was deductible. A 2007 law leveled the playing field by making mortgage insurance premiums deductible as well. While probably not the optimal policy – perhaps removing second lien deductibility would have been better – the net outcome was probably positive.

[4] As University of San Diego economist James Hamilton speculated in 2007, part of the incentive to assume inordinate amounts of mortgage risk may have been a product of housing's political sensitivity.

2. Rationalizing and streamlining federal housing programs

Every year, the U.S. government commits vast resources to support housing and mortgage markets. In 2009, the federal government dedicated $300 billion to directly subsidize housing.[5] This amount was split roughly evenly between tax subsidies and direct government spending. In all, these subsidies cut across several agencies and over 28 different programs to support both homeowners and renters. Some of these programs are aimed at reducing down payments, while others are focused on increasing the availability of mortgage loans or reducing a homeowner's tax liability.

As policymakers contemplate how to restructure the government's role in the housing sector, a bipartisan goal should be to ensure that all of the different housing programs have discrete objectives that are clearly and accurately accounted for in the federal budget. Until the last few years, the largest federal subsidy for homeownership was through tax expenditures (in other words by lowering a homeowner's tax liability). The single largest housing-related tax expenditure is the mortgage interest deduction. It will cost the federal government $637 billion in forgone tax revenue over the next five years. The next two largest line items are the exclusion of capital gains on primary residences ($215 billion over five years) and the deductibility of state and local property taxes on owner-occupied homes (another $151 billion). In total, tax expenditures that subsidize homeownership will reduce federal revenue by roughly $1 trillion over the next five years.[6]

One of the underappreciated consequences of all the actions to backstop the housing sector over the past few years is that the government now provides roughly the same amount of support for homeownership through spending programs as it does through the tax code. Unlike the fairly straightforward accounting and (on-budget) treatment of all the different tax provisions, the subsidies for housing on the spending side are more complex and confusing. On behalf of taxpayers, the federal government issues, guarantees, and insures mortgages. Taxpayers subsidize the redevelopment and sale of vacant properties and foreclosed homes. They subsidize housing vouchers, a public housing program, and at least eight more block grant initiatives for rental housing.

The budgetary costs of these programs are measured in three different ways – on a cash flow basis, on a present value basis, and on a present value basis adjusted for market risk. Without an apples-to-apples comparison, it is nearly impossible for policymakers to compare the effectiveness of these programs and to allocate scarce budgetary resources in ways that do the most good.

Fannie and Freddie are unfortunate examples of this principle. The Congressional Budget Office estimates that Fannie and Freddie cost taxpayers $291 billion last year, and will cost roughly an additional $90 billion over the next five years. Why are the losses from these GSEs so large? Since the government took them over, the taxpayer was put on the hook for three different, though related, types

[5] Congressional Budget Office. Economic and Budget Issue Brief: An Overview of Federal Support for Housing. November 3, 2009. (See for all numbers referenced in this paragraph.)
[6] Office of Management and Budget. FY 2011 Mid-Session Review: Estimates of Total Income Tax Expenditures For Fiscal Years 2009-2015.

of losses. First, there are losses rooted in all the mortgage-backed securities and guarantees already on the two firms' balance sheets (which total roughly $5 trillion). This is where the bulk of the losses are expected to come from. Second, there are losses that will come from their ongoing operations in the mortgage market where they create mortgage-backed securities by pooling payment streams from many mortgages and then add a guarantee that insulates the purchaser of the securities from the risk of default. The third category of losses will result from the firms modifying some mortgages in an attempt to prevent some foreclosures. When you add these categories up, Fannie and Freddie are likely to be the most expensive bailouts of the past few years, many times larger than AIG or Citigroup or even the entire and much-maligned TARP, which includes the bailout of the autos.

There appears to be a consensus now that the inherent flaw of the "government-sponsored" business was a lack of transparency and accountability with respect to the allocation of the underlying subsidy: profits went to private shareholders and losses were socialized, or ultimately covered by taxpayers. Nearly everyone (in the private sector) believed the government would come to the rescue of Fannie and Freddie if they ran out of capital in a crisis, yet this guarantee or federal backstop was never made explicit. For all intents and purposes, this "implied" guarantee is no different than a straight subsidy, yet it does not appear as a government obligation anywhere in the government's budget today.

Worse, the size of this subsidy was entirely at the discretion of the management of the GSEs. The more implicitly guaranteed "Agency debt" they issued, the larger was the dollar value of the subsidy captured by shareholders and management. The Congressional Budget Office (CBO) estimates that by 2004, the GSEs extracted a combined annual subsidy from taxpayers of $19.6 billion.[7] The problem was that activities that gave rise to a larger subsidy did not contribute in a meaningful way to a better functioning mortgage market. The Federal Reserve Board of Governors released a series of working papers (cited by Chairman Alan Greenspan in previous Congressional testimony) which made the point that the management could exploit the subsidy in ways that did not reduce borrowing costs for potential homeowners.

Certainly some portion of the subsidy was passed on to borrowers in the form of lower interest rates. But it was not established empirically that this transfer from one group of taxpayers to another was efficient. Most estimates suggest the subsidy amounted to between 7 and 25 basis points per year in reduced interest expenses[8] – and that the hidden cost of this subsidy over the past 20 years probably

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[7] Congressional Budget Office. Updated Estimates of the Subsidies of the Housing GSEs. April 8, 2004.
Note: Breaking out this 19.6 billion – the net benefit to homebuyers through lower mortgage rates from the two firms was $13.4 billion, and the residual benefit to Fannie and Freddie shareholders was $6.2 billion.
See also: W. Scott Frame (Financial Economist and Associate Policy Advisor, Federal Reserve Bank of Atlanta and Lawrence J. White (Professor of Economics, Stern School of Business): Charter Value, Risk-Taking Incentives, and Emerging Competition for Fannie Mae and Freddie Mac. February 2007.

[8] Dwight Jaffee and John Quigley of the University of California. The Government Sponsored Enterprises: Recovering From a Failed Experiment. August 2009.
See also: Wayne Passmore. Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs Federal Reserve Board, Washington, D.C. The GSE Implicit Subsidy and the Value of Government Ambiguity. 2005.

exceeded several hundred billion dollars.[9] Given that this transfer from one group of taxpayers (those providing the resources to underwrite the guarantee) to another (those benefitting from the marginally lower mortgage rate) was intermediated by the GSE management that was incentivized to maximize its own share of the subsidy, it seems highly unlikely that the GSE model was the most efficient mechanism to subsidize potential homeowners.

In addition, Fannie and Freddie were required by Congress to meet affordable housing goals, set annually by the Department of Housing and Urban Development (HUD) in accordance with The Federal Housing Enterprises Financial Safety and Soundness Act of 1992. These targets were designed to push some of the implicit subsidy to low-income families and underserved communities. But was this really the best way to deliver and target these subsidies?

While Fannie and Freddie are the largest providers of guarantees on mortgages, the federal government has many other programs that directly issue, guarantee, and insure mortgages and mortgage-backed securities. The Departments of Agriculture and Veterans Affairs directly issue and guarantee mortgages. The Federal Housing Administration (which is part of the Department of Housing and Urban Development) provides mortgage insurance to private lenders, who then issue mortgages for single- and multi-family homes. The Government National Mortgage Association (Ginnie Mae) guarantees securities backed by mortgages insured, guaranteed, or issued by all the different federal agencies.

The FHA is the largest of these programs today and it aims to extend access to homeownership for those buyers who have low savings, or moderate to low incomes, and can't qualify for conventional mortgage financing. The program insures mortgages in exchange for an insurance fee that is collected by the government. If a borrower defaults on an insured mortgage, the FHA pays the issuer or holder of the mortgage the remaining balance.

The Federal Credit Reform Act governs the budgetary treatment of FHA and the other programs run by USDA, VA, and Ginnie Mae. While all of these programs entail market risk, just like Fannie and Freddie, the cost estimates that the government conducts do not make adjustments for this type of risk. Essentially, this means that risky cash flows are being discounted at a risk-free rate.[10] The same basic premise is at work when the government fails to risk-adjust expected outcomes. As a result, government budget offices often estimate that programs issuing loan guarantees, like FHA, make the government money (or result in net savings to the government when the loans were initially made). It's easy to see how flawed initial cost estimates that don't account for market risk can be by looking at how

[9] Congressional Budget Office. Updated Estimates of the Subsidies of the Housing GSEs. April 8, 2004.
See also: Dwight Jaffee and John Quigley of the University of California. Housing Subsidies and Homeowners: What Role for Government-Sponsored Enterprises? January 2007.

[10] The concept of market risk can be confusing. Sometimes people misinterpret it as the risk that loans default, or interest rates rise. This is not exactly it; moreover, these risks *are* already accounted for under credit reform. At its most basic level, accounting for market risk means that in bad economic times, bad things are *more* likely to happen and getting repaid on a loan is worth *more*. So, in the private sector – investors demand a little extra (premium) for the risk that cannot be diversified.

FHA's portfolio has performed over time.[11] The original budget estimates for FHA from 1992-2008 projected that the program would earn the government $31 billion. But in reviewing how the program actually performed over that period, CBO estimates that the program cost taxpayers about $3 billion.[12] This is yet another example of how difficult it is for policymakers to write housing policy because the cost information is not always accurate or comparable across programs. All future subsidy estimates should reflect the present value of all cash flows associated with such mortgages – and include an adjustment for market risk.

As policymakers begin to review housing subsidies and consider alternatives to replace the GSEs, they must be careful to make clear the risks and costs of subsidizing housing investment. Government loan guarantees can appear to be low-cost since they pay out only if a borrower defaults and because official estimates often exclude a premium for market risk.[13] But we have learned that such guarantees are contingent on an accurate assessment of the various risks involved, and they can be extremely expensive if those risk assessments are wrong or if the defaults all happen to occur at the same time. Improperly scored loan guarantees also create moral hazard, as the implementing agencies can assume too much risk by lowering their lending standards over time.

Where possible, it would be more transparent and far more efficient for Congress to deliver housing-related subsidies directly to the homeowner. This is the primary way the government subsidizes food with food stamps or charity through the tax code. Private financial institutions would no longer have the ability to capture some of that subsidy for their managers and shareholders, as Fannie and Freddie did for so many years. Direct subsidies would also reduce the risk of another economic crisis.

Thus far, I have not commented on whether all of these subsidies are necessary or desirable. Regardless of the exact policy objective that Congress wishes to pursue (increasing or decreasing housing subsidies moving forward), it is important to note that all options can be achieved out in the open and on-budget. Trying to regulate private firms to complete a public policy mission will always be a flawed solution that is more likely to undermine transparency and miss targeted beneficiaries.

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[11] Clearly, not all cost estimates that turn out to be wrong over time are as a result of omitting market risk. Cost estimates for TARP, for example, did factor in market risk. Yet, over time the cost projections for this program have been lowered.

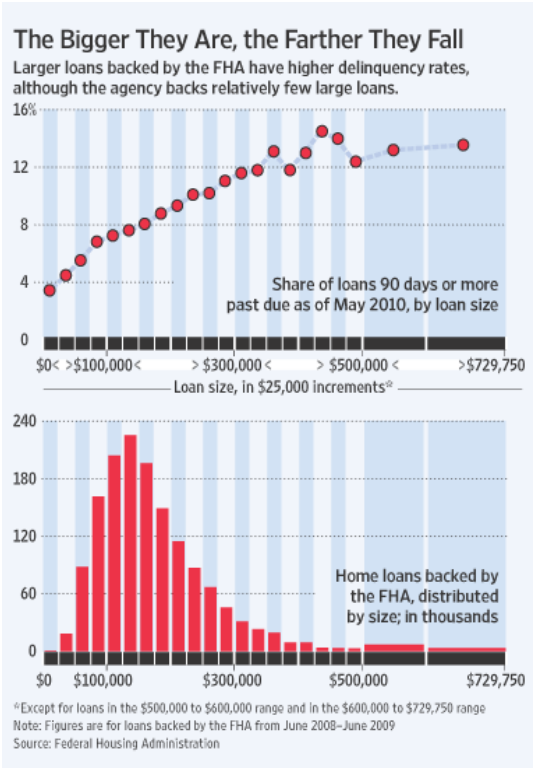
[12] Congressional Budget Office. Economic and Budget Issue Brief: An Overview of Federal Support for Housing. November 3, 2009.

[13] Right now, the Federal Credit Reform Act prevents score keepers, like CBO, for factoring in market risk, even when the organization believes that this factor should be considered in an official cost estimate. This is why CBO has increasingly resorted to using footnotes to show what scores would otherwise look like if market risk was incorporated in their calculations. See also: Jason Delisle, Credit Reform Act: Another Budget Loophole. Economics21. September 17, 2010. Jason Delisle, Small Business Loan Program Risks Taxpayer Losses, But Looks Free. Economics21. July 28, 2010.

3. Short-term and long-term drivers of reform

Important: many of the comments below are suggestions for policy changes that should be considered while the GSEs are still in conservatorship. By most accounts, the broader debate or process still has a fairly long way to go. Therefore, these statements should not be interpreted as tacit support for maintaining the current GSE structure in the long-term. Fundamental reform is necessary.

The future of the 30-year mortgage. There are three general pathways that policymakers could choose from: 1) the government could nationalize the GSE functions and become the sole guarantor of mortgage credit risk; 2) the government could decide to share this guarantee function (as it does now, presumably with structural improvements); or 3) the government could leave this guarantee function entirely to the private market. Many commentators have said this third option would mean the end of the 30-year fixed rate mortgage. My view is that lenders would likely still offer 30-year terms, but that the prices would fall causing required returns (i.e. mortgage rates) to rise (certainly relative to the traditional spread between fixed and adjustable rate mortgages). Banks could be made more inclined to fund mortgages if more were adjustable rate. It's important for policymakers to communicate the basics of a 30-year fixed rate mortgage with a "free" prepayment option. The ability of homeowners to "lock-in" today's payment for 30 years while simultaneously retaining the ability to refinance without penalty when interest rates drop is an enormous benefit. But this benefit was financed by transferring the interest rate risk to taxpayers through the guarantees provided by Fannie and Freddie. Since homeowners *are* generally taxpayers too, this transfer doesn't really make either group better off. And it penalizes renters. It is true that prospective homebuyers will be offered slightly less expensive mortgages under a system where the general taxpayer is bearing some of that long-term interest rate risk. But the key question is whether they would rather pay later (through future bailouts) or pay a true market price up front.



Loan limits. If a private conforming mortgage loan market is ever going to develop, the current loan limits for both FHA and the GSEs will have to be adjusted downward, eventually. In particular, I would recommend that this committee study further why FHA's loan limits are now much more in-sync with those for the GSEs, when historically they were lower. I recognize that the loan limits were all adjusted upwards during the crisis, but the rationale for having a lower limit for FHA seems to have been blurred over time. FHA requires a much lower down payment – and it has traditionally targeted its insurance to first-time homebuyers and low-to-moderate income families. There is no question that the higher limits have buoyed some high-priced housing markets. For example, in some areas the government is offering a 100% guarantee on a $700,000 home or

condominium with just a 3.5% down payment. However, the low down payments and relatively high loan amounts are starting to strain FHA's balance sheet. In fact, there is new data on FHA loans showing higher delinquency rates on larger loans.[14] The committee should also consider moving away from pegging the loan limits to home prices, and explore applying a means test, perhaps based on some factor of a state's median income level. Overall, there are too many subsidies in the housing space that are available to upper-income households.[15]

Loan-to-value ratios. Just like with FHA, a minimum cash down payment requirement should be applied to the GSEs. Credit enhancement products, like mortgage insurance, should still be available. Yet this minimum down payment requirement should be conceptualized in tandem with FHA. As long as FHA's down payment requirement stays at 3.5%, then perhaps a 5% level would be appropriate for the GSEs – in addition to credit enhancement on all loans with an LTV greater than 80. This amount could be scaled up over time to avoid disruptions in the mortgage market. Putting aside the exact number, establishing a floor would be an important first step – as research has shown that mortgage equity, or rather the lack thereof, is the most important predictor of default.[16] This committee should also encourage the Federal Housing Finance Agency to explore whether smart and effective countercyclical LTV ratios could be developed and implemented.[17]

Dodd-Frank implementation. The exact ways in which the housing-related provisions of Dodd-Frank are implemented – and how the market responds – will send important signals to policymakers about the degree to which the government would have to subsidize housing finance in the future to ensure the efficient allocation of credit. For example, the concept of a "qualified residential mortgage" within the new credit risk retention section could set the stage for how a "conforming mortgage" is defined in the future. Will private mortgage insurance be required? Will the regulation specify an LTV?

Covered bonds. This system involves banks issuing debt backed by a pool of mortgages that they hold on their balance sheets. The mortgage assets are then kept separate from their other assets. While these debt instruments are collateralized by mortgages, they are not like traditional mortgage-backed securities in that issuers are required to pay the interest and principal on the bonds regardless of how

[14] Nick Timiraos. Why FHA Loan Limits Could Fall In Your Neighborhood. The Wall Street Journal. September 23, 2010. The chart on the previous page is from this article.

[15] It is worth noting that the mortgage interest deduction (MID) is regressive since: (a) people in higher tax brackets get a bigger savings per dollar of interest; and (b) people in higher tax brackets are more likely to itemize. See also the work by Edward Glaeser and Jesse Shapiro, Harvard economists, who argue that the MID creates a bias against saving or alternative consumption choices.

[16] Krisopher Gerardi, Adam Hale Shapiro, and Paul Willen. Decomposing the Foreclosure Crisis: Housing Price Depreciation versus Bad Underwriting. Federal Reserve Bank of Atlanta Working Paper, 2009.

[17] Exactly how and why bubbles develop is still a mystery, one that the economic community is still studying vigorously. Many experts suspect they involve positive feedback loops between asset prices and the availability of credit. Higher and higher asset prices – or in the case of this most recent housing bubble, home values – can lead to more aggressive lending practices, which invariably lowers cash investment requirements (allowing for higher LTVs) and more fragile balance sheets for both households and the financial institutions that supply credit. As asset prices rise above their historical trend line, the risk of a decline grows greater. This is exactly when LTVs should inch lower, or down payments should increase slightly.

the underlying collateral is performing. While covered bonds are widely used in Europe, a market has not developed in the United States. The current Federal Home Loan Bank (FHLB) model is similar to covered bonds in that FHLBs "advance" loans to member banks in exchange for liens on mortgage collateral. Some speculate that the very existence of the FHLB system makes a covered bond market unlikely to develop in the U.S. because the pool of assets that would otherwise be segmented for covered bond holders can already be pledged to FHLBs at much lower interest rates.[18]

The public utility model. Over the past few months, several groups have advanced a proposal that would reorganize Fannie and Freddie as (one or more) public utilities. The model hinges on these utilities being privately owned by banks or other shareholders. Yet the idea would be to have them still function like a public utility. For many, the main difference between the utility model and the current structure would be that the current portfolios of the GSEs would be eliminated.

There are two versions of this concept being discussed right now. The first is where the guarantee fee rates (that the utilities charge) would be limited by a federal regulator. (Presumably, the regulator would also strictly monitor risk-taking generally.) The new utilities would be required to pay out a regular dividend to shareholders, which would enable the utilities to raise or attract private capital. This plan would probably require the utilities to be shareholder-owned to keep the liabilities off the federal budget. The other version of this idea, which amounts to a privatization of Fannie and Freddie, would have the bank cooperative (or owners) set the rates with just regular federal oversight (as opposed to hard limits or caps).

Important for both versions – but particularly the first version – is to think through how difficult it would be for the regulator to appropriately set the guarantee fee. The most well known analog would be electric or water utilities. However, guaranteeing mortgage securitization involves significant risk and pricing challenges, where electric or water is more straightforward. Would the new utilities be allowed to charge higher fees for guarantees on mortgages with weaker credit profiles (i.e. based FICO score)? What about charging different rates based on geography, as the utilities will presumably want to ensure that their guarantees are not just tied to one regional housing market? Even if Congress specifically authorized the utilities to use risk-based pricing techniques, determining exactly how much pricing control the government would have (perhaps delegated through its regulator) would be very important.

Traditionally, the federal government has a poor track record when it comes to pricing insurance, or with utilizing risk-based pricing tools. (See the flood insurance program, FDIC insurance, or the FHA example from earlier.) The government routinely projects to basically break even, or make a small profit in most years, only to later expose taxpayers to huge losses on certain occasions in the future. By its nature, insurance on correlated products requires the build-up of large reserves during good times to pay claims during bad times. But the government, historically, has not shown the discipline to allow for this build-up to occur. The result is insufficient premiums during good years and large deficits during tougher economic times.

[18] Christopher Papagianis. Reform the Forgotten GSE. Economics21. July 1, 2010.

What policymakers should look out for is a model that requires blended risk buckets, where guarantee fees on higher-quality mortgages subsidize the lower-quality ones that are perhaps part of a regulator's mandate for the utilities. If this were to happen, a private entity (that's not regulated in the same way) could undercut the utilities on price for the best quality mortgages. It would then be difficult to ensure that the utilities over time did not develop a relative weak portfolio of mortgages. In short, the utilities would fall prey to adverse selection. Of course, regulators could grant the utilities a monopoly to block competition. But, in my view, securitization is not a natural monopoly and it would be much better to maintain competition and market discipline, rather than rely on just safety and soundness regulation.

Even with competition, it will be a significant challenge to ensure that guarantee fees are set correctly. And, if the fees are set too low for too long, these utilities could very well become insolvent and require taxpayers to pick up the losses, just like with Fannie and Freddie. After all, it is important to remember that Fannie and Freddie would have likely failed even had they no portfolio to speak of because of the losses incurred on guarantees made on hundreds of billions of dollars of Alt-A mortgages that collateralized their MBS pools.[19]

Government's missteps in trying to correctly price mortgage insurance exposes taxpayers to great risk, even in a utility model, and especially if the utilities are insufficiently capitalized. As most everyone now agrees, GSE capital regulation was inadequate. They were required to hold 2.5% capital against their portfolio but only 0.45% capital on mortgage guarantees.[20] While this seems like a clear problem in retrospect, the system appeared to work well for a very long time (so long as mortgage underwriting standards remained high and house prices appreciated consistently). The lesson is that capital standards must be forward-looking. They should not be reduced during periods when default rates and losses are at cyclically low levels. This is especially true when the "cycles" seem to last for particularly long periods.

Conclusion.

While the previous sections reviewed some of the levers that will shape the ongoing transition in housing finance, it is crucial that policymakers also investigate bold new plans or approaches (that are very different from the current GSE model). Some ideas have already surfaced, but many more are in development. Particular focus should be paid to those that would deliver subsidies directly to individuals or families.[21] The more direct the subsidies; the easier they will be to target and transparently account for in the budget.

[19] Editorial. A Closer Look at GSE Credit Losses. Economics21. June 1, 2010.

[20] Given that guarantee fees averaged 0.2% per year, this meant that the capital reserves built for credit losses on $1,000 of mortgages amounted to just $6.50. In essence, the old capital and guarantee fee system would have been rendered insolvent by 2% default rates and 33% loss severities. A 2% default rate would be $20 of $1,000 of mortgages would go bad. A 33% loss severity on these bad mortgages would result in $6.67 in charge-offs, or losses in excess of the $6.50 in combined guarantee fees and capital.

[21] Charles Calomiris, Professor at Columbia University Graduate School of Business, Time to Introduce Minimum Downpayments for Mortgages. Financial Times. August 24, 2010.

Proposals discussed in this testimony could also impact, or slow, future home price appreciation. But, if new proposals are developed and advanced in a thoughtful manner, trade-offs can be managed – and other important benefits could be passed on, like improved access or affordability. In the end, the overarching goal should be to make taxpayers (i.e. current homeowners, prospective homeowners, and renters) better off through improved subsidy delivery (i.e. targeting) and budgetary transparency.