House Financial Services Committee

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Subcommittee on Insurance, Housing and Community Opportunity - Hearing on FHA Multi-family Programs

Testimony of Peter D. Schiff, economist, author and financial expert

Chairman Biggert, Ranking Member Gutierrez and members of the Committee, thank you inviting me here to testify today. My name is Peter Schiff, and I own Euro pacific Capital, a privately held stock brokerage firm. I am more widely known top the general public as an economist, author, speaker and advocate of the free enterprise system.

Unlike many of my co-panelists I do not come hear representing a specific coalition or group that has an interest in promoting the multi-family sector. I am here to represent the interests of the common U.S. taxpayer who will have to make good any liabilities incurred by the Federal government and who will have to live with the consequences of distortive government policies (as we all have been doing co conspicuously in recent years).

I also assume that I have been invited for my track record in forecasting problems in the housing market. A good deal of my reputation was established in 2007 and 2008 when my prior predictions regarding the dangers confronting the housing and credit market were spectacularly realized. There can be no question that if a hearing similar to this had been convened in 2006 to consider federal home mortgage policies, a roomful of qualified experts would have insisted that no crisis was then evident in the mortgage market. And so I can only thank this committee for its circumspection in this instance.

I have absolutely no objection to the idea that a healthy rental housing market is needed in this country, especially for those lower income individuals who depend on inexpensive housing options. However, I believe that market forces are sufficient by themselves. In general, free markets are the most efficient mechanism to ensure that market demands are met with the most cost effective options.

However, as the housing market has been the subject of an inordinate amount of regulation and market distorting tax and subsidy policies over the years, it has developed in ways that don't conform to the economic realities of our citizenry. In particular the construction and maintenance of rental units has been stunted by Federal policies have greatly favored home purchasers over renters.

The Federal Housing Authority and the Government Sponsored Entities of Fannie Mae and Freddie Mac, have undertaken herculean efforts to remove the credit risks associated with home mortgage lending. At the same time the tax code is replete with advantages for home owners, most notably the home mortgage tax deduction, that are not available to renters. In addition, the current policy of the Federal Reserve is to keep interest rates as low as possible, specifically to stimulate home purchases. Taken together, these factors have exaggerated the economic benefits of home ownership and have drawn excessive amounts of investment capital into the sector. Put simply, we are dedicated more resources to the single family home ownership market than we would if government had not decided to make home ownership a priority. As a result, financing for multi-family rental units have suffered.

Renting simply offers few of the regulatory advantages than owning does. So the country has not developed as many units as would have been the case has the government refrained from

interfering with the country's housing decisions. As it stands now, Americans have extremely low savings rates. The average American family now only has $7,000 worth of savings, which would not be nearly enough to afford a 20% down payment on the average American house. This would mean that the vast majority of Americans should be renters and not owners. Normally, these simple facts would attract investment capital to build affordable rental properties.

Critics of the free market like to argue that investors will ignore the needs of the poor as the profits are not significant enough to entice development. There is little in capitalism to support this position. Great riches can be made by serving the needs of low income people. Just ask Sam Walton. Wal-mart became successful by specifically targeting its inventory and pricing to low to moderate income consumers. Wal-Mart was able to expand, prosper, and attract investment capital without government guarantees or incentives. Such would also be the case in the low income housing market if government had not siphoned away investment capitol. If there is demand, a supply will be produced, A paucity of rental units relative to demand is all the incentive that industry needs.

But as is usual for government, legislators are now looking to ameliorate the pernicious effects of one set of distortive policies with another layer of regulations. This Committee may be looking to balance a playing field that never should have been tilted in the first place. By insuring a greater quantity of loans to developers of multi-family apartment properties, it is hoped that investment capital can be more willingly targeted to the market. However, hoping to micro manage capital flows always create a raft of unintended consequences.

Legislators also rarely consider the unintended consequences of their actions. Credit in the United States is a limited commodity. Money loaned for one purpose in unavailable to be lent for other purposes. Through its effort to take the risks out of home lending, the FHA has directed more credit into the real estate market that would otherwise been the case. That means these funds were not available to be lent to other enterprises which may have put the capital to work in areas that may have been more needed in the economy. I think capital should flow to where its needed most. Market determined interest rates is the factor that controls these flows. The FHA short circuits these signals and harms our economy. It's time that the FHA itself becomes short-circuited.

As a reminder to this Committee to proceed with caution and awareness, I submit as testimony portions of my newly released book, The Real Crash- America's Coming Bankruptcy that relate to how government policies created the housing bubble in the last decade, and how those policies continue to prevent a true turnaround in the market today. I hope with benefit of this hindsight, this Committee would abandon its instinct to over involve government in another area of the housing market and instead look to withdraw itself from areas that it has already devastated.

<u>Government Creates the Housing Bubble Through Bad Policy</u>

Excerpts from Chapter Two of*: The Real Crash – America's Coming Bankruptcy: How to Save Yourself and Your Country* (St. Martin's Press, 2012)

Politicians in both parties decided that government should promote home ownership. Democrats focused on helping poor people own homes by making mortgages easier to get. Republicans spoke of an "ownership society" that would promote personal responsibility.

Bankers and realtors, two of the most powerful interest groups in Washington, both agreed, and they helpfully pointed out ways the government could subsidize mortgages.

The biggest subsidy for buying a home is the tax deduction for mortgage interest. If you rent your home, none of your rent is deductible. If you buy your home outright, your costs are not tax deductible. But if you borrow in order to buy your house, all of the mortgage interest – which is a majority of the monthly payment for many homeowners – is tax deductible.

This is the single biggest tax break most people get, and it's a huge reason to buy a home – especially one that costs a lot. If you borrow $250,000 for a 30-year mortgage at 6 percent, your monthly payments will be about $1,500. About $1,250 of that is interest. In the first year, you'd pay almost $15,000 in interest, and thus be able to reduce your taxable income by $15,000. In seven years, you will have paid $100,000 in interest, saving at least $25,000 on taxes.

Also, you can deduct the interest on your second home. The only limit is that you can only deduct the interest on $1 million worth of mortgage.

This is a huge mortgage subsidy. Even though it's just a tax deduction, it's still a subsidy, because it distorts the market in favor of homeownership (more precisely, leveraged homeownership).

Another reason the mortgage deduction counts a subsidy: other taxpayers pay for it, at least indirectly. According to official estimates, the deduction reduces federal revenue by about $100 billion per year. Total revenue from individual income taxes is just above $1 trillion. So, if Congress abolished this deduction, and instead lowered all tax rates across the board, we could cut everyone's taxes by nearly 10 percent.

Put another way, almost 10 percent of your tax dollars go to benefit leveraged home-ownership by Americans.

Even if you're one of those homeowners getting the deduction, there's a chance you're still losing out on net. It's important to remember that subsidizing something doesn't just benefit the people buying it. In fact, it often benefits the sellers more.

In the case of mortgage subsidies, there are plenty of "sellers" who benefit. First is the homeowner who sold you the home. Decreasing the monthly cost of owning a home also drives up the price of buying a home. After all, you're not the only one with access to the mortgage-interest deduction. The deduction boosts demand, thus boosting price.

As a result of the home mortgage deduction, homebuyers end up paying more for their home. So while they get to deduct their interest payments, those payments are much higher due to the price effects of the deduction. Take away the excess demand generated by the deduction, and home prices would fall. True, mortgage interest would no longer be deductable, but the payments would be much lower. Most homebuyers would be better off without the deduction.

The real beneficiary of the deduction is the seller, who sells his house at an inflated price. Of course if he uses the proceeds to trade up to an even larger house, he losses out as well. The only winners are those who sell and rent, trade down to less expensive houses – or professional homebuilders, who sell houses for a living.

Realtors also profit. Greater demand for buying a home means more homes bought, meaning more commissions. Also, higher demand means higher home prices, meaning higher commissions. Lenders also profit from the home mortgage interest deduction, which

encourages people to not only to buy, and thus take out mortgages, but to take out bigger mortgages than they otherwise would.

The combined influence of realtors and lenders insured the home mortgage interest deduction. The story of the deduction goes back to 1913. When the income tax was created, all interest – including personal loans and business borrowing – was tax deductible. After credit cards became ubiquitous in the 1980s, Congress ended this deduction, but thanks to the lobbying of the realtors and mortgage lenders, mortgage interest was spared, and it remained deductible.

Home ownership gets other special tax breaks, with one big one driving the idea of a home as an investment: the capital gains exclusion. Most investments you might make – say, you start a business, or invest in stock – are subject to capital gains taxes. Your home is not. If you live in your home for two years, you can sell it and earn up to $500,000 in profit on tax free. This is another huge subsidy to homeownership as compared to other investments, and it encouraged serial home flipping during the bubble years.

Fannie and Freddie: 'one of the great success stories of all time'

The greatest drivers of the housing bubble, after the Federal Reserve, were the Government Sponsored Enterprises Fannie Mae and Freddie Mac, who were supposed to make housing more affordable, but who ended up creating a housing bubble instead.

In 2004, if you asked the average Washington politician about Fannie and Freddie, you would have been told that these GSEs were sound, essential, and independent of government. In 2007, as the housing and mortgage crisis became apparent, that same politician would have said that Fannie and Freddie were doing just fine, and they wouldn't need a bailout. Come late 2008, those very same politicians were crying that taxpayers needed to bail out both.

In 2004, when Alan Greenspan came before the Senate Banking Committee, the issue of the GSEs came up. Senator Chris Dodd, the largest Congressional recipient of housing related campaign contributions said of them, "I, just briefly will say, Mr. Chairman, obviously, like most of us here, this is one of the great success stories of all time." In July 2008, after the New York Times reported that the federal government might have to take over Fannie and Freddie, stocks of both GSEs fell nearly 50 percent.

Dodd chastised the sellers and those of us saying Fannie and Freddie were bankrupt. "There is no reason for the kind of reaction we're getting. These fundamentals are sound. These institutions are sound. The have adequate capital. They have access to that capital. And this is a reason for people to have confidence in these GSEs—in Fannie and Freddie." In the end, Fannie and Freddie collapsed, and rather than let them fail, the government bailed them out and took them over.

..When you think of the 2008-2009 economic crisis, some words might come to mind: mortgaged-backed securities, housing bubble, subprime mortgages, cronyism, moral hazard, derivatives.

When you think of these words, you should think of Fannie Mae and Freddie Mac.

Franklin Roosevelt created the Federal National Mortgage Association during the Great Depression in order to stimulate home buying ("FNMA" became "Fannie Mae). In 1968, Congress privatized Fannie, and a couple of years later, created a competing agency, the Federal Home Loan Mortgage Corporation, or Freddie Mac.

What these agencies do is to buy mortgages from lenders. You can imagine how this opens up the mortgage market. Without someone buying up mortgages, a bank is somewhat limited in how many loans it can make – after all, even with fractional reserve banking and loose reserve requirements, your loans still need to be backed up by some amount of assets.

The problem with Fannie and Freddie is that they knew that while their profits were real – and huge – there risk was not real. More precisely, the politically connected bigwigs who ran the halls at these GSEs knew that if their companies ever lost money, the taxpayers would bail them out.

This government guarantee was not explicit, but implicit. Of course, Fannie's biggest boosters denied there was any guarantee. Barney Frank, in 2003, famously said:

"There is no guarantee. There's no explicit guarantee. There's no implicit guarantee. There's no wink-and-nod guarantee. Invest and you're on your own. Nobody who invests in them should come looking to me for a nickel. Nor anyone else in the federal government."

Fannie Mae officials also fiercely denied they enjoyed any subsidy. But they did. Fannie Mae was able to borrow at lower interest rates, because lenders realized that taxpayers would bail them out. Near-zero borrowing costs had two detrimental effects. First, it allowed Fannie and Freddie to buy up massive amounts of riskier mortgages. Second, it made it impossible for anyone to compete with these GSEs..

So, the net effect of Fannie and Freddie was to drive down lending standards and interest rates. Had there been no government subsidized secondary mortgage market, selling mortgages would have been harder for banks, and lending standards and interest rates would have been higher.

This was exactly the point. Fannie was in "The American Dream Business," they would say. Their job was get people to buy homes they who otherwise wouldn't buy homes, and to make everyone pay more.

Some like to point out that subprime was the real problem and that Fannie and Freddie did not guarantee subprime loans. While that is technically true, they were the biggest buyers of these loans in the secondary market. In fact, without their lavish appetites far fewer subprime loans would have been originated. Not only did their demand help fuel originations, but it helped legitimize the investment merit of the securities. Because the private sector originated subprime loans without any official government backing, many like to blame capitalism, or more specially Wall Street greed, for the problem. However, take the Fed and Fannie and Freddie out of the picture, and subprime would have been a trivial part of the mortgage market.

Fannie Mae and Freddie Mac were the most important players in driving the Fed's excess capital into housing, but other policies helped, too. The Community Reinvestment Act was one.

The CRA has changed plenty over its 30 years, but the general thrust was always the same: it empowered federal regulators to pressure banks to make more loans to low-income people.

George W. Bush pushed his "ownership society," too. Bush spoke at a church in Atlanta in 2002 about "the American Dream," meaning homeownership. The President named some of the new homeowners he had just met and said, "what we've got to do is to figure out how to make sure these stories are repeated over and over and over again in America."

To this end, he proposed the “American Dream Downpayment Act” to help folks buy homes even if they couldn’t afford downpayments. The law, passed in 2003, provided grants of up to $10,000 to cover downpayment, closing costs, and some home repair for first time homebuyers of below-average means.

Of course, the tax preferences above drove the housing market, too. Housing prices soared. At the same time, the American dream was hijacked. Instead of referring to the upward mobility made possible by American capitalism, it was redefined to mean getting rich just by buying a house and extracting equity as it magically appreciated.

Come 2006 and 2007, the housing bubble popped. At first, pundits said it was just a little crisis in subprime mortgages. It wasn’t. I won’t go through the entire story of what happened in the housing and credit markets in 2006 through 2009, but it was a replay (on a much larger scale) of the popping of the dot-com bubble.

When bubbles are built upon foundations of massive leverage, the bust brings real destruction. On the smallest level, consider the guy who took out an adjustable rate mortgage in 2005 to buy a big house with a very small down payment. When his home value drops 30%, it’s not only his on-paper net worth that suffers. His rate adjusts in 2010, and he can’t refinance because his house is underwater. If he sells his house, he won’t be able to get enough money to cover his outstanding mortgage and the bank will take all his savings.

Banks took a huge hit when everyone realized that the trillions investors and banks had spent on mortgage-backed securities were worth a fraction of what they were supposedly worth. All the financial institutions that had been providing credit to the economy were suddenly in trouble, and couldn’t lend like they used to. Those businesses that depended on credit for their day-to-day operations were in trouble.

Never was this on display as clearly as 2008. In March, the Fed bailed out failed bank Bear Stearns. In July, Congress passed housing bailouts. In early September, the federal government took outright ownership of Fannie and Freddie (since then, according to Congressional Budget Office numbers, taxpayers have poured $310 billion into the two GSEs).

In mid-September, the Federal Reserve, with no authorization from Congress, created brand new Enron-like special-purpose entities to buy an 80 percent stake in insurance giant AIG. This was an attempt to bail out a collapsing financial sector. It wasn’t enough.

Most important, though, was the way the string of bailouts fit the government pattern: prevent the economy from correcting itself. Once again, rather than let an inefficient allocation of resources shake itself out, politicians and central bankers decided that the right cure for a drinking binge was “the hair of the dog that bit you.”

That is, when confronted with a crisis caused by government-created moral hazard, cheap money, and central planning, Washington responded with more moral hazard, even cheaper money, and heightened central planning.

Corporate welfare and business subsidies have always been around, but the Bush and Obama administration gave government a role more central in the economy than it have ever played. The government owned insurance companies, mortgage companies, automakers, and more. Washington was giving handouts to power companies, banks, small businesses, big businesses, manufacturers, and every type of business imaginable.

Government had become a venture capitalist, an insurer, and even an owner of the private sector. If the private sector – even with prodding from Washington – wasn’t going to step up and prevent a downturn, the government would.

It was just one more step down the same path. When the dot-com bubble popped, they replaced it with a housing bubble. When the housing bubble popped, they replaced it with a government bubble. The greater problem is that while we at least have something to show for the first two bubbles, a few good Internet companies and some pretty nice McMansions, no such benefits will remain when the government bubble pops.