Testimony of Dr. Anthony B. Sanders
Before the House of Representatives Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Topic: "The Future of Housing Finance: The Role of Private Mortgage Insurance"

July 29, 2010

Mr. Chairman, and distinguished members of the Committee, my name is Dr. Anthony B. Sanders and I am the Distinguished Professor of Finance at George Mason University and a Senior Scholar at The Mercatus Center. It is an honor to testify before the House of Representatives Committee on Financial Services today.

In the first quarter of 2010, The FHA insured $52.5 billion of home-purchase mortgages while Fannie Mae and Freddie Mac purchased $46 billion of loans. This represents over 90% of the purchases and/or insurance of residential mortgages in the United States. FHA Commissioner David Stevens was quoted as saying: "Having FHA do this much volume is a sign of a very sick system."

Very sick indeed. The proliferation of government programs for homeownership, purchase/insurance of low down payment loans by Fannie Mae, Freddie Mac and the FHA and tax incentives for home ownerships were largely responsible for the housing bubble that occurred during the 1998-2006 period.[1] After the burst of the housing bubble and the near collapse of the banking industry (103 banks have failed so far this year, ahead of the pace of 140 for last year), we are left with a largely government-controlled residential mortgage market. The problem with government control of the mortgage market is that public policy and risk management are intertwined and the public policy side dominates prudent risk

[1] See Figure 1 for the Case Shiller 10 City Index that demonstrates that house prices (as measured by the CS index) rose from 78.23 [Oct '96] to 226.17 [June 2006]. Not surprising after the GSEs added $8 trillion for housing finance over this time period.

management resulting in bubbles and devastating bursts.[2] This is not a controversial point for those who have studied the crisis.[3]

The Affordable Housing Crisis Cycle

The "Affordable Housing Crisis Cycle" must be broken. This cycle occurs when trillions of dollars are pumped into the housing finance market to support home ownership. The result is a housing bubble where house prices rise dramatically making housing unaffordable for many households (particularly in high cost cities such as San Francisco, Los Angeles and New York).[4] As a tool to help those households that can no longer afford home ownership, the government then responds with lower down payment standards (through the government purchase/insurance of low down payment mortgages).[5] See Figure 2 for the extent to which Fannie Mae, Freddie Mac and the FHA fueled the housing bubble with low down payment mortgages. An economic slowdown or housing crash follows with losses borne by taxpayers and the very households that the government was trying to help.[6] Given that there is a reasonable housing alternative in the form of renting (rather than owning), it is time to rethink the Crisis Cycle.

---

[2] For a discussion of government intervention in the housing market, see Darrell Issa, "Unaffordable Housing and Political Kickbacks Rocked the American Economy," Harvard Journal of Law & Public Policy, Vol. 33. **www.harvard-jlpp.com/33-2/407.pdf**

[3] See, for example, Ed Pinto, "Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study." 2010.

[4] See Figure 1 for the historic Case Shiller 10 City Index

[5] The recent Case Shiller Home Price Index indicates that San Francisco has increased 18% over the last twelve months. If the government purchases/insures low down payment mortgages in this expensive metropolitan area, they are perpetuating the cycle. When house prices fall (further recession, increase in taxes, etc.), American taxpayers are yet again on the hook for affordable housing goals.

[6] In 1988, I was quoted in the New York Times as advising against putting lower income households at risk of being financially damaged due to a declining housing market. http://www.nytimes.com/1988/10/11/us/dukakis-in-levittown-offers-a-plan-to-help-young-families-buy-homes.html?pagewanted=2

We can break this cycle by getting private mortgage insurers back in the game and down size government involvement in the housing finance area. How do we get the private mortgage insurance industry back in the game? The first step, of course, is to get the banking industry back into the lending game.

Why Banks Aren't Lending

Why aren't banks lending? It's been 3 years since the start of the financial crisis and almost 2 years after the crisis' darkest days in September 2008. Growth of the private sector is simply not possible without bank lending to business and consumers. Small and medium size businesses have proven to be the engines of employment growth and the banking system is the primary vehicle that lends to small businesses and households; this lending generates growth. But the only loans that banks are originating are those that they can sell (or obtain insurance from) the Federal government (Fannie, Freddie, FHA).

So why aren't banks lending for their own portfolio? Their unwillingness to lend stems from a combination of bad loans on their books and fear on behalf of our bank regulators that lending to business or consumers in a slow economy is "too risky." Banks are flush with funds and should be able to make loans in their respective markets. Since banks face low borrowing costs (and in some cases at virtually zero), they have chosen to invest in U.S. Treasury securities with no default risk. Why make risky loans to small businesses when the government encourages banks to invest in riskless assets?

Fannie Mae, Freddie Mac and the FHA Crowd out the Private Sector

This is a classic "crowding out" phenomenon. The Federal government offers explicit guarantees on residential mortgages which makes it difficult for the private sector to compete (since the Feds can under price the insurance and drive out the competition). In addition, the government can create policies that discourage banks from lending (such as encouraging banks to invest in Treasuries rather than make risky loans).[7]

Not only does the government crowd out the private sector, they "compete" with each other for market share. As I mentioned before, the FHA (thanks to its low down payment programs) is actually insuring more mortgages in the first quarter of 2010 than Fannie Mae and Freddie Mac. And when both the FHA and Fannie/Freddie "compete," the private market suffers. This "shell game" where the government decides to cut back one agency (or quasi-agency) and expands operations in another agency results in the same old problem: too many low down payment mortgages are being originated and purchase/insured by the government if we want to avoid another plague of loan defaults and a re-inflating of the housing bubble.

The crowding out phenomenon is exacerbated by the raising of the loan limits for Fannie Mae, Freddie Mac and the FHA. See Figure 3 for the loan limits for both the FHA and Fannie/Freddie for before the stimulus and after the stimulus. As one can see, Fannie Mae and Freddie Mac had considerably lower loan limits prior to the stimulus (and FHA had lower loan limits than Fannie and Freddie). Currently, Fannie Mae, Freddie Mac and the FHA have considerably higher loan limits, particularly in the more expensive cities for housing. When the big three housing agencies have an unfair advantage in offering insurance (with a government guarantee) and the loan limits are so high that they capture the vast majority of eligible home loans, the private sector is effectively crowded out.

[7] Stuart Gabriel and Stuart Rosenthal found that the GSEs were responsive to HUD Affordable Housing Goals, but that the GSEs crowded out private lenders in that these loans were not held on bank balance sheets. See "HUD Purchase Goals and Crowd Out: Do the GSEs Expand the Supply of Mortgage Credit?"

Recommendations

1. Fannie Mae, Freddie Mac and the FHA must downsize their market shares to open up the market to the private sector again. This can be done, in the short run, by curtailing the government purchase/insurance of low down payment loans. Although Chris Dodd feels that "passage of such a requirement would restrict home ownership to only those who can afford it," he fails to acknowledge that there is a rental market for housing (where Fannie Mae, Freddie Mac and HUD are active participants) for which many household would be better served.[8]
2. Alternatives to Fannie Mae and Freddie Mac, such as covered bonds and improvements to private label securitization must be implemented. Covered bonds represent a private market solution to securitization that has been operating in Europe for centuries. The private label securitization market will return when investors grow more confident that proper underwriting is occurring (with a securitization certificate that travels with the loan and replaces or supplements the securitization representations and warranties).[9]
3. In order for capital to return to the market, it is necessary to restore confidence in the market. The newly created Bureau of Consumer Financial Protection is generating significant uncertainty in the minds of investors as to how this Agency will function. Some of the new regulations the agency is authorized to promulgate may not occur for

[8] Raphael Bostic, a Senior Official at HUD, acknowledges that homeownership is not for everyone and the pursuit of homeownership rates is misguided. http://www.washingtonpost.com/wp-dyn/content/article/2010/07/20/AR2010072005946.html

[9] See Andrew Davidson and Anthony Sanders, "Securitization After the Fall" for a discuss of recommendations to help return the securitization market. http://merage.uci.edu/ResearchAndCenters/CRE/Resources/Documents/Davidson-Sanders.pdf

another two years. That represents two more years of capital waiting on the sidelines to learn what the rules are before investors decide to play the new game. Congress should pass clear guidelines and provide assurances that limit the reach of the new agency.

4. The long run structure of Fannie Mae and Freddie Mac must be resolved, particularly since it was fundamentally missing from the Financial Reform legislation. But fundamental change in the nature of Fannie Mae and Freddie Mac is not possible if the Administration and Congress insist that there must be an explicit guarantee. The explicit guarantee requires government oversight and control; I do not see any way that the explosive combination of public policy (e.g., low down payment and relaxed credit standards) can exist with prudent risk management. It failed in the housing bubble and crash and nothing has been done to prevent this from occurring over and over again.

Thank you for letting me share my thoughts with you.

Figure 1. The Case Shiller Ten City Index.

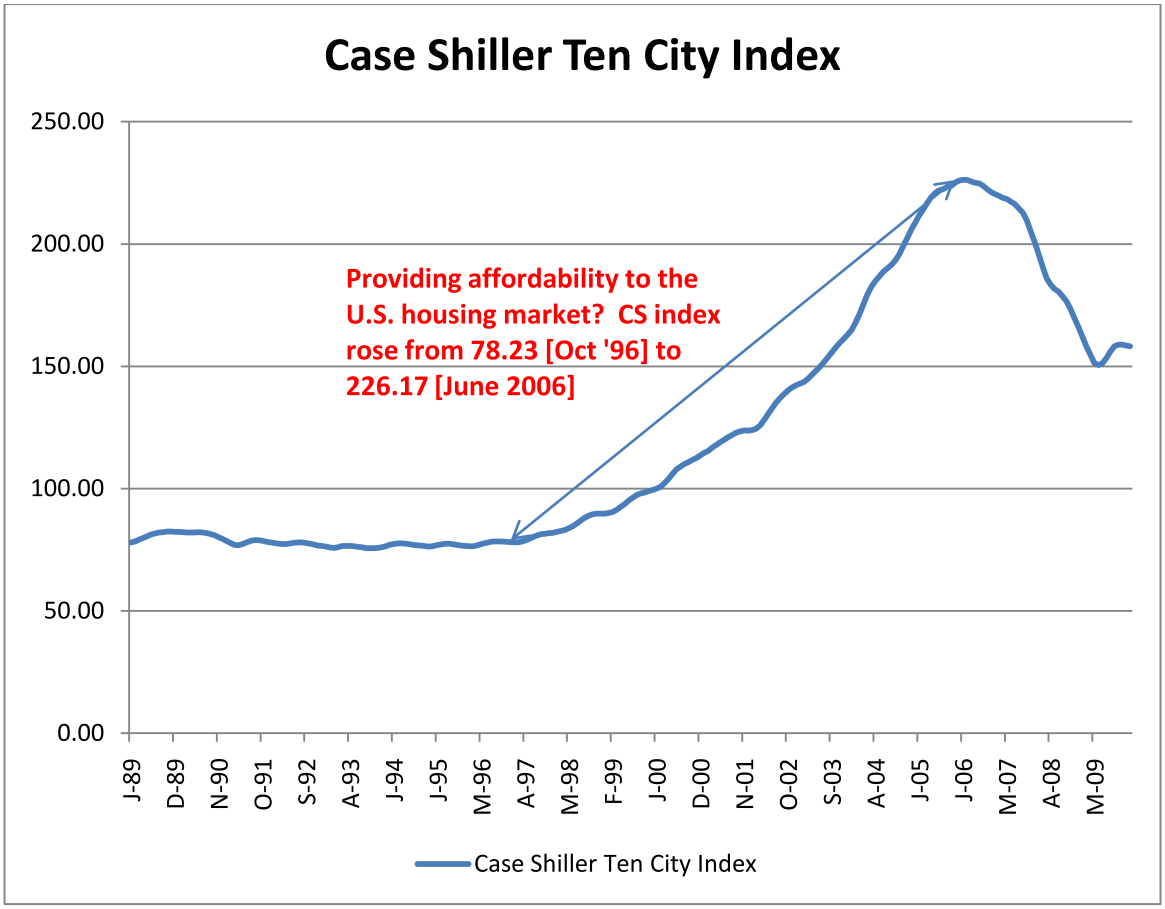
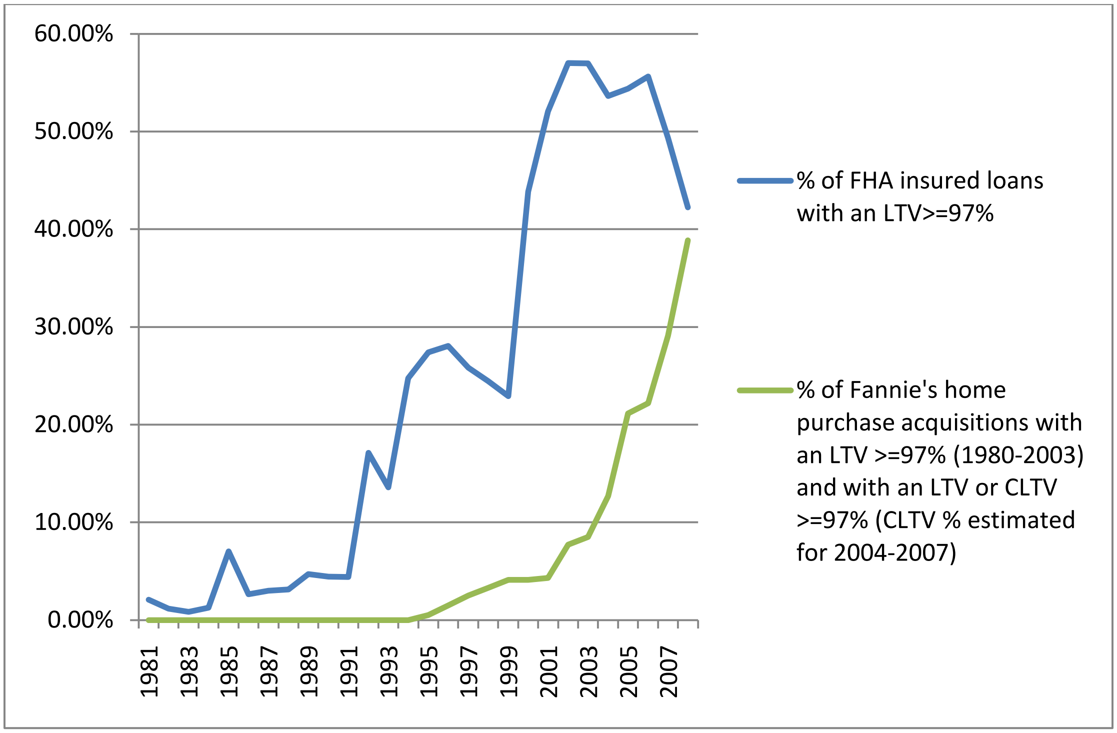


Figure 2. Low Down Payment Loans for FHA and Fannie Mae



Source: Ed Pinto, "Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study." 2010.

Figure 3. GSE vs FHA Loan Limit: Pre Stimulus and Current