"TOWARD A NEW HOUSING FINANCE SYSTEM"

Testimony prepared for

"IMMEDIATE STEPS TO PROTECT TAXPAYERS FROM THE ONGOING BAILOUT OF FANNIE MAE AND FREDDIE MAC"

ON

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BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT-SPONSORED ENTERPRISES

U.S. HOUSE OF REPRESENTATIVES

WRITTEN TESTIMONY
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Chairman Garrett, Ranking Member Waters, and other distinguished members of the Subcommittee:

Thank you for the invitation to testify at today's hearing on the "Immediate Steps to Protect Taxpayers from the Ongoing Bailout of Fannie Mae and Freddie Mac." It is an honor to be here today to discuss the proposed legislation and the broader need for a reinvented housing finance system. Transition issues are important. It is necessary to take steps to reduce the current near-total reliance on federal support for housing. Nonetheless before we can dismantle the current system we will need a comprehensive set of reforms to reinvent the housing finance system.

In a reformed system, among other goals, private capital must be accountable and at risk. However, today in the part of the market in which private capital is not competing with federal supported mortgage finance, the jumbo market, there is a very limited supply of private capital. This absence of financing activity points to the need for comprehensive reform to address the substantial absence of private financing even in those portions of the market that are not served by the GSEs.

Comprehensive rules of the game to support a transparent and accountable system and to prevent the recurrence of systemic failure are not yet in place. Until they are, we will not be able to replace the current reliance on federally supported supply of capital with functioning capital markets. Thus, the important challenge is restructuring a system to encourage private capital flows to re-enter the market and to ensure a sustainable housing finance system going forward.

A number of proposals have set forth necessary components of a comprehensive system. They have in common shared goals. These include systemic stability, consumer and taxpayer protections, and private capital accountability.

These proposals have in common a role for the federal government in preventing races to the bottom and the undermining of sensible lending standards to assure a sustainable system going forward.

In my own research, I stress the need for standards and transparency to counter the information failures that allowed reckless mortgage products and underwriting practices. There is an important role for collective or government action to mandate transparency, standards, and information to allow for all market participants, investors, borrowers and regulators, to prevent risks from becoming uncontrollable through market discipline and regulatory oversight. In the absence of standardized information and reporting such discipline and oversight are not feasible.

While numerous explanations exist for the housing bubble that precipitated the financial crisis of 2008, including monetary policy, encouraging affordable homeownership, and irrational expectations, none of these can fully explain the housing bubble, much less the parallel commercial real estate bubble. In co-authored research with Adam Levitin, "Explaining the Housing Bubble" (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1669401 and forthcoming in the *Georgetown Law Review*), we demonstrate that the bubble was a supply-side phenomenon attributable to the underpricing of risk.

Due to complexity and the lack of transparency and standardization, it was difficult for investors and regulators to identify the extraordinary increase in mortgage credit risks as reckless underwriting and risky mortgage products increasingly overtook the system. We show that the market failed to identify these risks and in fact lowered the price of risk as risk increased in unparalleled ways. Neither regulators nor investors could be aware in real-time of the growth of tail risk and the growth on the margin of risky products and underwriting practices.

While proposed legislation being considered today addresses the underpricing of the government guarantee fee, it is also true that the private market significantly underpriced risk. In fact, the private sector was first to underprice risk. The resulting information failure enabled low mortgage rates, risky products and reckless underwriting to persist causing the housing price boom, which concealed the risk.

This underlying information failure must be addressed if mortgage securitization is to be sustainable going forward. Sustainable mortgage securitization is important for the continued availability of the long-term fixed-rate mortgage, which itself is critically important to limit the negative consequences of imposing interest-rate risk on borrowers. Homeowners lack the capacity to take measures to hedge this risk, with potentially severe consequences for household financial stability and for the stability of the overall economy.

Moreover, while comprehensive reform is necessary for a stable housing finance system in the long run, the transition to a new system must be accomplished while taking into consideration the current fragility of housing markets.

On March 29, Standard & Poor's released the latest update to the Case-Shiller Home Price Indices, which show, from January 2010 to January 2011, home prices fell 3.1% in the twenty-city composite index. In inflation-adjusted terms, housing prices have breached their 2009 bottom and are again on the decline. Part of this decline is due to a weak labor market, with unemployment at 8.9%; part is due to the excess inventory, including the shadow supply of houses; and part is due to the tightening availability of credit. Expectations of decline could once again become self-fulfilling leading to a downward spiral of prices. Federal housing support is still critical to preventing this; thus, legislative proposals need to be considered in the context of the weak housing markets.

Now I turn to addressing each of the specific legislative proposals. The first three raise questions of implementation.

"The Fannie Mae and Freddie Mac Accountability and Transparency for Taxpayers Act," proposed by Representative Biggert , imposes reporting requirements on the Inspector General of the Federal Housing Finance Agency. While reporting is of course useful, the appropriateness of reporting every communication between the Fed or Treasury and the

GSEs, as this law requires should be considered in light of market-moving implications and the potential for market-moving outcomes that are not consistent with fundamentals.

"The GSE Debt Issuance Approval Act," proposed by Representative Pearce, requires the Treasury to approve new debt issuance by Fannie and Freddie and to justify approval of GSE debt issuance, seven days before issuance. My understanding is that the Treasury already had the authority to do this and it should. The specific seven-day oversight of this by Congress may or may not be practical. More to the point, the overarching question is whether this encourages the intended outcome of less reliance on federal support for housing finance.

"The GSE Risk and Activities Limitation Act," proposed by Representative Schweikert, prohibits the FHFA Director from approving any new GSE product. This is consistent with the current prohibition by FHFA with one major exception. This exception currently allows for adding new products for loan modification purposes. Prohibiting this could inhibit or prevent the implementation of techniques to resolve current or impending loan defaults, a problem which is part of the shadow supply overhang that is impeding the housing market recovery.

"The GSE Mission Improvement Act," proposed by Representative Royce, repeals affordable housing goals, without suggesting what might replace them. As we re-envision the housing finance system, there will be a need to re-envision the goal of non-discriminatory access to housing finance. In the academic literature, there is substantial evidence that the affordable housing goals were not responsible for the housing bubble, evidenced that is reviewed in my previously cited paper, "Explaining the Housing Bubble." We note there also that the housing bubble coincided with an equal commercial real estate bubble and bust, which could not have been prevented by removing the affordable housing goals.

On the "The GSE Credit Risk Equitable Treatment Act of 2011," proposed by Chairman Garrett, I agree the comments made today by Edward DeMarco, Acting Director of the Federal Housing Finance Agency, who stated that "Enterprise single-family mortgage securities are structured with a 100 percent risk retention by the securitizer (i.e., the Enterprise)," which is beyond the five percent retention required by Dodd-Frank. Nonetheless, the broader issues raised by Section 941 are perhaps the most important of everything that is being considered today. Empirical evidence on risk points to the importance of sound underwriting. Based on the evidence, assuming well-structured mortgage markets, the requirement of twenty percent down payments without a mortgage insurance offset is way beyond what is necessary for a safe and sound housing finance system.

Now let me turn in brief to the three remaining proposed laws. Each constrains management decisions and, while well-intentioned, could raise costs to taxpayers.

"The Equity in Government Compensation Act of 2011," proposed by Representative Bachus, constrains compensation.

“The Portfolio Risk Reduction Act,” proposed by Representative Hensarling, caps the GSEs’ portfolios at $250 billion in five years. While it is ultimately desirable and necessary to reduce the portfolio, constraining the path of reduction in this way may not optimize taxpayer returns.

Finally, “The GSE Subsidy Elimination Act,” proposed by Representative Neugebauer, directs the GSEs to increase guarantee fees within two years to a level that “appropriately reflects risk of loss as well the cost of capital allocated to similar assets held by other fully private regulated financial institutions.” Fannie and Freddie have credit risk but not interest rate risk, as banks do which needs to be taken into consideration. Moreover, the very level of the necessary guarantee fee should be determined by the expected default risk, including the potential for systemic risk. This is indeed the important issue going forward.

Policymakers and the nation as a whole must make fundamental decisions about the shape of our Nation’s finance system going forward. The issues being considered today are of critical importance to the Nation’s future. I thank you for the opportunity to testify today, and I welcome your questions.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name: SUSAN WACHTER	**2. Organization or organizations you are representing:**
3. Business Address and telephone number: [redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? ☐ Yes ☑ No	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?** ☐ Yes ☑ No
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7. Signature: Susan M. Wachter	

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