Testimony of

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"State of the Housing Market: Removing Barriers to Economic Recovery"

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Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify on housing policy and the state of the housing market. I am a professor at the University of Maryland's School of Public Policy and a faculty affiliate of the Center for Financial Policy at the Robert H. Smith School of Business at the University of Maryland. I am also a visiting scholar at the American Enterprise Institute and a senior fellow with the Milken Institute's Center for Financial Markets. I was previously Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009.

The continued weak state of the housing market and the toll of millions of foreclosures already, millions more families still at risk of losing their home, and trillions of dollars of lost wealth all reflect the lingering impact of the collapse of the housing bubble and ensuing financial crisis. A range of policies have been undertaken over the past several years aimed at the housing market—a recent summary from the Department of Housing and Urban Development lists 10 separate policy actions.[1] These can be grouped into two broad categories. What might be seen as "backward-looking" policies seek to avoid foreclosures on past home purchases through actions such as incentives for mortgage modifications and refinancing. By avoiding foreclosures, these policies both assist individual families and help reduce the supply of homes for sale (and in the overhang of the so-called "shadow inventory") and thus reduce downward pressures on home prices that in turn affect household wealth and the broad economy. In contrast, "forward-looking" policies seek to boost demand for home purchases, such as with the first time homebuyer tax credit and the Federal Reserve's purchases of mortgage-backed securities (MBS).

The common feature of these housing policies is their limited effectiveness. To be sure, these policies have done something: MBS purchases resulted in lower interest rates for families buying a home or refinancing a mortgage; some 930,000 homeowners have benefited from permanent mortgage modifications through the HAMP program; and so on. But relative to the scale of the weakness in home prices and housing market demand, and especially compared to the tragically huge number of foreclosures, the set of housing market policies to date appears to have underperformed compared to expectation set at each policy unveiling. Moreover, these programs have involved considerable costs for taxpayers, with the benefits accruing mainly to a relatively small group of recipients. And on top of the millions of foreclosures not prevented by the policies of the past several years, there is likely another

[1] See the appendix of the January 2012 HUD-Treasury Housing Scorecard:
http://portal.hud.gov/hudportal/documents/huddoc?id=JanNat2012_Scorecard.pdf

huge wave of foreclosures set to take place in the next year or two, with many of these representing foreclosures that were delayed but not ultimately prevented by policies to date.

This experience is important to keep in mind as the Congress contemplates a range of new and expanded housing policy proposals from the administration, along with a white paper from the Federal Reserve that covers similar ground. Broadly speaking, the proposed actions look to provide homeowners with reduced monthly payments through government-assisted refinances; to lower principal mortgage balances; and to speed the pace at which vacant homes become rentals. The goal, as with all policies throughout the crisis, is to have fewer foreclosures and stronger consumer spending. These policies are well-intentioned.

Unfortunately, there is every reason to believe that the new policy proposals for streamlined refinancing and principal reduction are likely to have the same modest impact—and at an even worse tradeoff in terms of cost to taxpayers for each foreclosure avoided than for the policies to date. Simply put, we have learned that mortgage modification programs are difficult to implement and execute because of the intrinsically one-at-a-time nature of the transactions involved. And the expansions of some programs, such as considerably increased payments from the government to motivate reductions in mortgage principal, face less promising conditions now for being effective than was the case when many of these policies were launched in early 2009. Three years of a weak job market have forced many of the borrowers who might have been helped by reduced payments or a lower mortgage balance into foreclosure.

There are other approaches that can be taken to help heal the housing market and speed the recovery of home prices and construction while reducing the pain for American families. This testimony first provides a critical analysis of recent policy proposals and then discusses alternative steps that the Congress might consider. The goal of these policies is for the housing sector to once again contribute positively to the U.S. economy and to American society—to have a housing system that works for families looking to buy homes, for investors with funds to lend, and for taxpayers who deserve a stable financial system and protection from another expensive bailout.

Mass Refinancing Proposals

It is useful to consider a specific example that raises the question of whether the latest policy proposals from the administration will perform differently than previous initiatives. The White House fact sheet for the administration's refinancing proposal for a single family, owner-occupied principal residence promises that there will be "no barriers and no excuses" (top of page 3) and no new appraisal or tax forms involved in enabling eligible homeowners to refinance their mortgages into an FHA-guaranteed loan with lower monthly payments. Without access to tax forms, however, it is not clear how lenders are meant to verify that a home is indeed owner-occupied—the natural mechanism would be to look at the address on the homeowner's 1040 tax form. Indeed, the lender could even just examine the address on the IRS form 4506 by which the borrower requests that a copy of the tax return be sent to the lender; this would be less intrusive than having the lender examine the 1040 itself but is again offlimits in the new proposal. A lesson of the past several years is that unverified mortgage applications (so called “no doc loans”) are convenient but do not end well for either lender or borrower.

The alternative of having the lender send someone out to the home also runs counter to the stated policy proposal—there are to be no appraisals, and the need for possibly repeated site visits to confirm the owner-occupied status seems to be exactly the barriers and red tape that are not allowed (not to mention the intrusiveness of having someone peek through the windows to figure out who is living inside).

On the other hand, lenders clearly will not be willing to allow borrowers to simply attest that they are refinancing an owner-occupied property. After all, this was a common misrepresentation during the housing bubble and it would be outrageous for lenders not to check carefully for loans receiving a government-backed guarantee such as with the new refinancing proposal involving the Federal Housing Administration (FHA). Moreover, the administration has launched an investigation into possible abusive behavior in mortgage origination and servicing; presumably this investigation and the similar effort launched in 2009 will deter lenders from allowing potential fraud. But this leaves the problem of how to comply with the contradictions between the proposed policy and the rhetoric by which it has been introduced.

This is just one type of hurdle that implementation of the latest proposal for refinancing of non-GSE loans is likely to face—the desired ease of the refinancing is defeated by the conditions of the proposal itself.   Perhaps there is some workaround in the offing for this and the other inevitable problems of implementation that have plagued past efforts, but it is now more than two weeks since the proposals were launched by the President in his State of the Union address and there is no legislative text to consider these important details. Similarly, the Fed’s white paper on housing proposals includes a broad discussion of the possible beneficial impacts of widespread refinancing, but does not get into the operational details that are crucial to achieve actual policy outcomes.[2]

The lower monthly payments for homeowners that would result from the proposed FHA-based refinancing scheme for non-GSE loans and the expansion of the previous HARP (Home Affordable Refinance Program) for GSE loans announced in October 2011 are meant to both reduce foreclosures by improving affordability and to boost the economy through increased spending by families with greater free cash flow as a result of lower mortgage payments. That is, refinancing would be a sort of stimulus analogous to sending a monthly check to qualifying households. It is clear that mortgage credit was too easily available in the run-up to the crisis, and a good argument can be made that the pendulum has swing too far in the other direction now so that some credit-worthy borrowers do not have access to mortgages for home purchases or refinancing. An important lesson of the current situation, however, is to highlight the problem of having the government so intricately involved in setting mortgage standards. It would be preferable for private suppliers of capital to fund housing and to take on the risks and rewards of credit decisions. This provides an important motivation for moving forward with housing finance reform. With Fannie Mae and Freddie Mac in government control under conservatorship at

[2] This is in some ways reminiscent of the 2008 Hope for Homeowners program that likewise had only modest impact in reducing foreclosures.

present, it is inevitable that public officials will be involved in the choice of credit standards. The driving force for these decisions should be to find the appropriate balance between protection for taxpayers against overly risky loans while maintaining access to credit for homebuyers and rebuilding a responsible private mortgage market—and not to have these decisions motivated by a desire to implement a backdoor fiscal stimulus.

Indeed, stimulus is likely the best way to view the impact of the two mass refinancing proposals involving HARP 2.0 for GSE-backed mortgages and the FHA for non-GSE loans. Both refinancing proposals would benefit borrowers with high loan-to-value (LTV) mortgages, including underwater borrowers whose mortgage balances are greater than the value of their home and who thus have an incentive to walk away from their home and allow a foreclosure. The current proposals, however, are restricted to borrowers who have been in their homes since at least mid-2009 and have been nearly current on their payments for a year (six months with no late payments and no more than one 30-day late payment in the preceding six months). In other words, the refinancing assistance would go to borrowers who have shown that they want to stay in their home and have done so for several years in the face of declining home prices and a weak job market. To be sure, these borrowers will benefit from the lower mortgage payments. But the targeted population for the refinancing has already shown that they are resistant to foreclosure, meaning that the program will avoid relatively few incremental foreclosures per dollar of taxpayer expense. This leaves stimulus as the main motivator for mass refinancing.

As noted in the Fed's white paper and in recent analysis provided by the FHFA in a letter to Representative Elijah Cummings, both refinancing proposals involve costs to taxpayers because the U.S. government is a beneficial owner of mortgages through MBS holdings of both the Federal Reserve and the GSEs. This is not to say that U.S. government asset holdings should come before homeowners—not by any means. The point is that the costs of the refinancing proposal must be weighed against the benefits, keeping in mind that the principal benefit is through a relatively targeted fiscal stimulus going to particular homeowners (and not to renters, who tend to have lower incomes than homeowners). One could imagine policymakers calling for another round of taxpayer-funded fiscal stimulus such as through providing checks or other tax benefits, but this should be debated openly. It is hard to imagine that a new stimulus would involve the relatively narrow targeting of the population of homeowners with high LTV's who bought homes at a particular time period and who have been able to afford their monthly payments.

In a time of tight fiscal constraints, one could also imagine seeking to focus costly government programs on homeowners who could be seen as most in need of assistance and for whom refinancing programs might be most effective. The refinancing proposals are limited by the amount of the mortgage but one could further restrict this government assistance to people with desired income ranges. The White House has recently defined the middle class as households with the median income plus or minus 50 percent.[3] With median household income around $52,000, this would imply limiting the refinancing program to households with incomes of no more than around $78,000–the top of the White House

[3] See http://www.whitehouse.gov/sites/default/files/krueger_cap_speech_final_remarks.pdf

definition of middle class. Alternately, one could use the approximately $64,000 median income of family households (that is, leaving out individuals, who tend to have lower incomes). This would give a maximum income for the middle class as defined by the White House as $96,000—rounding up would then give $100,000 as the maximum income limit for eligibility for the administration's FHA refinancing proposal. One could imagine applying this income limit to all FHA programs in order to best focus the taxpayer-provided subsidy implicit in FHA activities to households most in need.

It should be noted as well that the February 2011 report to Congress on "Reforming America's Housing Finance Market" by the Treasury Department and HUD stated that the "FHA should return to its pre-crisis role as a targeted provider of mortgage credit access for low- and moderate-income Americans and first-time homebuyers."[4] The report notes that the FHA market share (around 30 percent in early 2011) is already substantially above what Treasury and HUD see as the historical norm of 10 to 15 percent. The administration's refinancing proposal thus represents a policy reversal that both goes in the wrong direction for housing finance reform and increases the taxpayer exposure to losses by the FHA when recent analyses indicate that the agency is likely to require a taxpayer bailout of $50 billion or more as a result of its existing obligations.[5]

The administration proposes to offset the costs of the FHA refinancing proposal with a tax on large banks. As Treasury Secretary Geithner noted at a press conference last week, "there are pockets where credit is tighter than it needs to be, including mortgage finance and small business." The bank tax would expand these pockets, with costs of the tax passed through to borrowers in the form of higher interest rates and reduced availability of credit.

It is the case, as noted in a recent analysis from the Federal Reserve Bank of New York, that foreigners have meaningful holdings of U.S. mortgages in the form of mortgage-backed securities and would bear some of the cost of the refinancing proposals.[6] Given the U.S. fiscal imbalance and ongoing current account deficit, it is likely that the United States will rely on inflows of foreign capital for the foreseeable future. Policies that are seen as unexpected or unfair to foreign investors might then result in reduced demand for Treasury securities and other dollar assets and thus higher financing costs for American borrowers including the United States government. This is not a reason to avoid a refinancing proposal, but the potential impact on future interest rates should be taken into account in evaluating the costs and benefits.

Similar considerations apply to domestic suppliers of capital for housing finance. Buyers of mortgages and mortgage-backed securities plainly take on refinancing risk—the compensation demanded for this risk accounts for part of the spread between yields on GSE-backed MBS and Treasury securities. Continued expansions of refinancing proposals, however, could give rise to the belief that mortgages going forward have embedded in them a new feature that gives borrowers easier access to a downward

[4] See http://portal.hud.gov/hudportal/documents/huddoc?id=housingfinmarketreform.pdf.
[5] See Joseph Gyourko, "Is FHA the next housing bailout?" November 11, 2011.
http://www.aei.org/papers/economics/financial-services/housing-finance/is-fha-the-next-housing-bailout/
[6] See Joseph Tracy and Joshua Wright, "Why Mortgage Refinancing Is Not a Zero-Sum Game," January 11, 2012.
http://libertystreeteconomics.newyorkfed.org/2012/01/why-mortgage-refinancing-is-not-a-zero-sum-game.html

adjustment of interest rates than was believed to be the case in the past. This regime change would then translate into market demands for higher yields on mortgage-related securities and thus higher interest rates going forward. In other words, current homeowners would benefit from refinancing but future ones would pay more. This is akin to the impact of so-called "cramdown" proposals that would change the bankruptcy code to allow reductions in the principal balance of mortgages: current homeowners would benefit from having reduced debt but future homeowners would face higher interest rates and reduced availability of credit. Relatively risky future borrowers, who tend to have lower incomes, would be most adversely affected.

As noted above, there are reasons for concern about the impact and cost-benefit calculus of mass refinancing programs. Nonetheless, it is possible for the administration to move forward with some aspects without Congressional action. The expanded HARP refinancing is moving forward though financial firms' computer systems are reportedly not yet fully ready for the new program. Some FHA guidelines could be adjusted as well to streamline the appraisal process and include some additional mortgages (though the expansion to underwater loans would require Congressional action). In other words, there are steps that could be taken without waiting for the inevitable rejection of the proposed bank tax.

Expansion of the Home Affordable Modification Program (HAMP)

The HAMP program involves government payments to incentive mortgage modifications that lower homeowner payments and thus seek to prevent foreclosures. Lenders (typically servicers acting on the behalf of the beneficial owners of mortgages) have an incentive to make such modifications to avoid the considerable costs involved with foreclosure, but many institutional features slowed the modification process—to widespread frustration, including at the Treasury Department when I served as Assistant Secretary. The difficulty with a modification is to find the right targeting, amount, and structure of the modification that balances effectiveness with cost. A lender will not want to modify a loan for a borrower who can afford their original payments or for a borrower who could not afford the lower payments resulting from a modification that has an economic value equal to the cost of foreclosure. The presence of underwater borrowers is an important consideration, since an underwater borrower has an incentive to walk away from a home even if the payments are affordable and the lender will not recover the full value of the loan in a foreclosure. But a modification involving principal reduction is especially costly for the lender and gives rise to important concerns about strategic behavior and spillover effects such as having other homeowners seek unnecessary principal reductions. A further complication is that the weak economy of the past several years has meant that some homeowners who could initially afford the lower payments of a modified loan might suffer an income decline such as from a job loss and then "redefault" on the modified loan (that is, default). It has been said that this combination of factors leaves a potentially narrow aperture through which to make a successful modification.

HAMP uses taxpayer dollars to tip the balance toward increased modifications. Under certain conditions, the Treasury puts in money to pay for part of the cost of the modification. The selection criteria are crucial to the outcome of the policy and involve profound challenges. It is natural to focus taxpayer dollars as tightly as possible on incentivizing incremental modifications rather than providing a windfall for ones that lenders would have done on their own and to avoid as much as possible providing an incentive for homeowners to stop paying their mortgages in order to qualify for assistance. At the same time, implementing a tighter screening to focus on the right set of borrowers translates into fewer incremental modifications.[7] These considerations presumably went into the cost-benefit calculations that were done with the original HAMP program, which was initially predicted to lead to three to four million modifications by the end of 2012 but had chalked up somewhat less than one million permanent modifications through December 2011.

A key feature of the administration's recent HAMP proposal is to substantially increase the taxpayer-provided payments to lenders that reduce principal as part of a modification for underwater borrowers. This is a relatively costly way of reducing monthly mortgage payments compared to reducing a borrower's interest rate. If the focus of modifications is on affordability, it would be more effective to extend the term of a loan and reduce interest payments rather than writing down principal. Still, one could justify a focus on principal reduction if the goal is to avoid foreclosures by homeowners who can pay their mortgage but choose not to because they are underwater. The key issue is whether this is a cost-effective approach.

A concern about the expanded HAMP incentives recently announced by the administration is that this is a policy that would have been much more cost-effective in terms of a lower cost to taxpayers for each foreclosure avoided in early 2009. Three years later, underwater borrowers who are still in their homes have demonstrated their attachment to it. To be sure, a principal reduction will benefit homeowners. But the cost to taxpayers will be much larger with the expansion of HAMP payments, and the impact in terms of foreclosures avoided is likely to be much modest than in 2009 given that the target population has made it this far. This leaves a high cost-benefit ratio from the HAMP expansion—presumably a much higher cost-benefit ratio than was judged to be prudent when the program was designed in 2009.

A natural question then is to consider what is different today than in 2009 that results in the apparent imperative to reduce foreclosures in 2012 regardless of the cost effectiveness of the policy tools involved. This is a worrisome approach to policymaking and to the stewardship of taxpayer resources.

Pilot Program to Transition Real Estate Owned (REO) Property to Rental Housing

The aftermath of the bubble has left the U.S. economy with too many homes for sale or in the so-called "shadow inventory" of homes that will be for sale once prices firm. The announcement by the FHFA of a

[7] For more discussion, see Phillip Swagel, April 2009, "The Financial Crisis: An Inside View," http://www.brookings.edu/economics/bpea/~/media/Files/Programs/ES/BPEA/2009_spring_bpea_papers/2009_spring_bpea_swagel.pdf

pilot program to transition REO properties to rentals is a welcome step to speed up the adjustment of the housing market to post-bubble conditions. Facilitating purchases of vacant homes by firms that can manage them as rentals will help speed up the market adjustment, at least modestly. This program will not be helpful in all parts of the country, but it will be most useful in areas in which foreclosures and vacant homes are especially acute. The inventory of REO properties held by Fannie Mae and Freddie Mac has been declining as properties are sold while inflows of new REO dwellings have slowed as the result of legal uncertainties surrounding the foreclosure process. But there is likely to be a wave of foreclosures in the pipeline and having this program ready will be useful. At the same time, it will be important to ensure that buyers of REO properties bring capital to the table rather than relying heavily on the GSEs for financing. With Fannie and Freddie under taxpayer control, this would constitute yet another government involvement in the housing sector. GSE financing of institutional buyers would increase the firms' balance sheets and thus taxpayer exposure to risk.

The importance of putting vacant homes to use can been seen in the combination of rising rental costs and declining prices for home sold under "distress" such as following a foreclosure.[8] Overall indices of home prices such as the S&P/Case-Shiller index declined to post-bubble lows in the most recent data for November 2011, while the FHFA purchase-only price index rose in November and has moved slightly above the low point of March 2011. Downward price pressures involved in distressed sales likely contribute to differences between these price indicators. This conclusion is bolstered by recent press reports citing RealtyTrac as calculating that bank-owned foreclosures and short sales sold at a discount of 34 percent to non-distressed properties in the third quarter of 2011.

As discussed in the Fed white paper, the use of short sales and deeds-in-lieu of foreclosure can reduce losses for lenders and provide a better financial outcome for borrowers (and with greater dignity than a foreclosure). Recent press reports indicate that use of these tools is growing, along with payments by lenders to homeowners willing to move out rather than go through the foreclosure process. With the foreclosure process taking 24 to 36 months in states with a judicial foreclosure process, quite large payments could be rational on the part of lenders.[9] The Treasury's Home Affordable Foreclosure Alternatives (HAFA) program similarly provides modest payments to market participants (servicers, homeowners, and investors) to choose short sales over foreclosure. Given the substantial private incentives for these short sales to take place it is not clear that the HAFA program is needed.

Housing Market Adjustment and Alternative Policy Approaches

Housing markets naturally adjust slowly because the typical homebuyer must sell their existing home at the same time that they buy a new one, while the stock of homes evolves slowly given that homes tend

[8] For longer discussions from which this is drawn, see "The Housing Bottom is Here" on http://www.calculatedriskblog.com/2012/02/housing-bottom-is-here.html and Prashant Gopal, February 7, 2012, "Banks Paying Homeowners to Avoid Foreclosures," Bloomberg News. http://www.bloomberg.com/news/2012-02-07/banks-paying-homeowners-a-bonus-to-avoid-foreclosures-mortgages.html.

[9] See Gopal, op cit. http://www.bloomberg.com/news/2012-02-07/banks-paying-homeowners-a-bonus-to-avoid-foreclosures-mortgages.html

to last for 50 years or more. The adjustment has been especially slow in the wake of the crisis and recession as the result of reduced household formation that has diminished the natural growth in demand for housing.

The goal of policy moving forward should be to facilitate the ongoing adjustment and quicken the recovery of both housing prices and construction. By definition, a recovery commences only after the market hits bottom. It is desirable to lift off the bottom quickly. Fostering a stronger overall economy is perhaps the most important element of this, since a stronger economy will boost housing demand, including through increased household formation. Other policies could be useful as well, notably actions that facilitate a more rapid market adjustment and that strengthen demand.

Rhetoric about not wanting the market to hit bottom is a combination of empty and factually incorrect—after all, a housing market recovery by definition will start only after the market hits bottom. What is desirable is for the recovery to start immediately—that is, for the bottom to have been reached already.

In considering housing policy going forward, it is important both to avoid policies that will prolong the housing downturn or lengthen the time at which the market rests on the bottom. This implies that it would be valuable to resolve legal and regulatory uncertainty facing mortgage servicers and originators as quickly as possible. To be sure, past wrongdoing should be punished, notably including inappropriate foreclosures on servicemen and servicewomen. On the other hand, a lengthy period of uncertainty will affect the willingness of banks to take on housing-related risks. This concern has practical relevance for the administration's recent proposals. Bank A, for example, will naturally hesitate to refinance a loan originally made by Bank B even with an FHA guarantee if there is a concern about the possibility of future litigation. The same applies to concerns about the ability of banks to foreclose on borrowers in default—if a mortgage is no longer a securely collateralized asset, then there would be widespread ramifications to the detriment of future homebuyers. Imagine the cost of financing a home purchase with an unsecured loan facility such as credit cards.

There are important institutional and legal overhangs slowing the housing recovery, including lawsuits and regulatory actions involving the MERS title system, settlement discussions related to so-called robosigning, putbacks of bad loans to originators by the GSE, and perhaps others. Again, there should be appropriate consequences for past wrongdoing and steps to avoid repetition. But there is also a value in a rapid resolution of these uncertainties so that the mortgage financing system can once again operate effectively to the benefit of U.S. homebuyers and homeowners. A desire to punish the financial industry sits awkwardly with the desire for a housing recovery. It is important to keep in mind as well that some foreclosures are unavoidable—just as hundreds of thousands of foreclosures took place in years with a strong housing market before the recession. It is important to have a foreclosure process that is accurate and fair and that can move forward responsibly but without unnecessary delays. Foreclosures are difficult and tragic events for households. Yet some foreclosures are inevitable. A housing rebound ultimately requires that adjustments including unavoidable foreclosures take place.

Government policies could also play a positive role in improving industry weaknesses that have been highlighted in the various judicial actions. The MERS titling system, for example, arose in part to compensate for the varying information systems by which property title information is kept, generally at the county level. A useful initiative would be to develop standard formats for these data. This would preserve local control over intrinsically local decisions and information, but facilitate nation-wide transmittal and analysis of information. Similarly, better coordination of information regarding second liens would facilitate some additional modifications based on bargaining between owners of the primary mortgage and second lien.

Finally, moving forward with housing finance reform remains vital for a sustained housing market recovery. It is now a year since the Treasury Department and HUD released a report on housing finance reform and concrete action is long overdue. Uncertainty about the future of the housing finance system, notably the role of the government, will make private providers of capital hesitate to fund mortgages. This leaves government officials to make crucial decisions regarding credit availability that are better left to market participants with incentives based on having their own capital at risk.

I have written at length elsewhere about steps for housing finance reform, including the future of Fannie Mae and Freddie Mac.[10] The steps involved in moving forward with reform involve a combination of several policy levers: bringing in private capital to takes losses ahead of taxpayers; reducing the scope of any guarantee; and increasing the price or reducing the quantity offered of the guarantee. Moving forward in these dimensions would help increase the role of the private sector in housing finance and reduce government involvement and taxpayer exposure. Importantly, these steps could be taken without a firm conclusion about whether there will be a government guarantee on housing at the end. Enough progress in utilizing these policy levers would eventually lead to a housing finance system that is entirely private, but the path to a private system would involve a mix of private capital and incentives backstopped by a secondary government guarantee. This means that starting with reform that involves a secondary government guarantee does not rule out ending up with a fully private housing finance system. The key is to move forward expeditiously in order to provide increased certainty about future market conditions and thereby bring private capital back into housing finance. A useful additional step would be to make transparent the budgetary impact of GSE activities. The use of the TARP to compensate the GSEs for costs related to the administration's housing proposals, for example, obscures the underlying reality that the financial consequences of activities of both the TARP and the GSEs show up on the public balance sheet. H.R. 3581, the Budget and Accounting Transparency Act that passed in the House of Representatives earlier this week, provides a step forward in ensuring desirable clarity in

[10] See Phillip Swagel, "The Future of Housing Finance Reform," October 2011 paper for the Boston Fed Annual Research conference, http://www.bos.frb.org/economic/conf/LTE2011/papers/Swagel.pdf, and Phillip Swagel, "Reform of the GSEs and Housing Finance," Milken Institute White Paper, July 2011. http://www.milkeninstitute.org/pdf/HousingFinanceReform.pdf

budget treatment.[11] It would useful as well for the GSEs to make available loan-level data that facilitates analysis of market conditions and helps private participants to enter the housing finance market.

Recent news reports indicate that Freddie Mac is developing a pilot program under which private owners of capital would purchase a security that absorbs losses on a pool of loans ahead of Freddie Mac itself. This would have Freddie in a senior position and outside investors in a first-loss position. Such a structure would have the GSEs lay off housing risk on private market participants while obtaining a market-based indication of the return market participants require to take on housing credit risk. Such a pilot program would thus test the appetite of the private market for first-loss risk on housing assets in exchange (presumably) for higher returns, indicate the market's assessment of the value of the government guaranteed on mortgages, and illuminate the path leading to a reduced role of the government in housing finance. We have learned that it is difficult for the government to price its guarantee for taking on risk, making it extremely useful to have a market-based indication. One could imagine applying such a framework to FHA loans as well to reduce government exposure and protect taxpayers compared to the current model under which the FHA does not share risk.

Conclusion

A revitalized housing sector and an end to the sadly elevated number of foreclosures would mark salient progress in moving past the consequences of the housing bubble and financial crisis. Government policies can usefully contribute to the needed adjustment. But it is essential to be clear about the costs associated with proposals such as those from the administration that would expand efforts to use taxpayer funds to avoid foreclosures. It is far from clear that these efforts will be effective and even less apparent that they will have a positive impact commensurate with the taxpayer resources involved. It would be better instead for Congress to consider steps that would hasten the housing market adjustment, facilitate the return of private capital into housing finance, and bring the housing sector more quickly to the point at which home prices and construction activity lift off the bottom into recovery.

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[11] For more discussion, see Chris Papagianis and Phillip Swagel, "Put Fannie and Freddie on Federal Books," Bloomberg View oped, January 22, 2012. http://www.bloomberg.com/news/2012-01-23/put-fannie-and-freddie-on-federal-books-papagianis-and-swagel.html