To the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate

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For Hearings On:

"Housing Finance Reform: Should there Be a Government Guarantee?"

Written Testimony of

Dr. Dwight M. Jaffee

Booth Professor of Banking, Finance, and Real Estate
Haas School of Business
University of California, Berkeley
Email: Jaffee@haas.berkeley.edu
Phone: (510) 642-1273

Mr. Chairman and Members of the Committee, I welcome the opportunity to discuss with you today the future role of the government in the U.S. mortgage market. There is now a widespread consensus that Fannie Mae and Freddie Mac—I will refer to them as the GSEs—should be closed as soon as practical. It is thus timely to consider the best means for replacing the mortgage market functions that have been carried out by the GSEs.

Current discussions focus on two primary alternatives for replacing the GSEs. The first alternative is to allow the private markets to replace the existing GSE functions, with the possible addition of expanding the FHA or a similar government program with the goal to augment the supply of mortgage funding for lower-income borrowers and multifamily housing. The second alternative is to create a new government program that will provide investors in conforming mortgages with an explicit government guarantee against losses due to default.

My research leads me to a strong endorsement of the private markets as the preferred alternative for two reasons. First, there is strong evidence that the private markets are fully capable of carrying out all mortgage market functions to a standard substantially higher than actually experienced under the GSE regime. Second, experience indicates that a program of government guarantees of conforming residential mortgages is highly likely to leave taxpayers, once again, to pay the high costs of defaulting mortgages. I will now briefly explain the basis for these conclusions.

I have recently carried out research that compares the mortgage and housing market performance of the U.S. with that of 15 major Western Europe countries. This is relevant because none of these European countries provides an amount of government assistance to their housing and mortgage markets close to that provided in the U.S., and, in particular, none of them has any institution comparable to our GSEs. Nevertheless, the mortgage and housing markets of these countries have significantly outperformed the U.S. markets on all available measures.

The attached Table 1 provides the full data from my research. The first important fact is that the U.S. homeownership rate, 67.2% at year-end 2009, is exactly equal to the average rate of the 15 European countries, with the home ownership rates of 7 European countries actually exceeding that of the U.S. This is all the more remarkable because the population density of these countries far exceeds the U.S. and some of these countries—Austria and Germany for example—have longstanding social traditions to postpone the date of first home purchase.

Second, the average of U.S. mortgage interest rates has significantly exceeded the corresponding average for the 15 European the countries. The lower European mortgage rates are mainly the result of the much lower default rates for European mortgages. Even with the current financial distress in Europe, their mortgage default rates have remained very low. The financial distress currently facing many European banks is mainly the result of losses on construction loans and sovereign debt, and not from home mortgages.

I expect private markets will deliver lower mortgage rates in the U.S. for the same reason as in Europe. That is, private investors will require the mortgage loans they purchase to be originated under high underwriting standards. The decline in U.S. mortgage rates that will result from greater safety will offset the pressure toward higher mortgage rates that will result as the GSE subsidies are eliminated. Equally importantly, the switch to safer mortgages will preclude any future replay of the huge economic and social costs we are currently facing from high foreclosure rates on risky mortgages.

As to the second alternative, proponents of new government guarantees for U.S. home mortgages often start by pointing out that the private mortgage markets are currently moribund, and that they see no mechanism through which the private markets can displace the current dominant role of the GSEs. In contrast, I believe the current dominant position of the GSEs is simply the result of crowding out, whereby any entity with a government guarantee will always displace comparable private market activity. In my view, a private market revival will follow rapidly once we remove the current GSE subsidies.

I would also like to shed light on two further issues—I would say myths--raised by the proponents of expanded government guarantees of residential mortgages. The first issue is their contention that the 30-year, fixed-rate, mortgage can exist only with a government guarantee program. This is in error for two reasons. First, the primary risk on long-term, fixed-rate, mortgages is interest rate risk, and neither the GSEs nor the proposed government guarantees provide any protection against this risk. Second, without even considering government guarantees, the credit risk on long-term mortgages is actually lower than on, say, adjustable rate mortgages. The proof is that private markets in the U.S. and Europe have long provided long-term, fixed-rate, mortgages and at accessible interest rates.

The second issue raised by advocates of new government guarantee is that the guarantees are essential to the continuing existing of the so-called TBA forward market for mortgage securitization. This is also in error for two reasons. First, as long as the existing FHA and GNMA programs exist, and most likely they will expand, the TBA market will continue to exist. Second, and more fundamentally, the private markets for hedging interest rate risk have proven highly satisfactory for controlling the pipeline risk that arises in private label securitization in the U.S. and covered bond issuance in Europe. I have to add that the arguments to protect the existing TBA market primarily reflect the wish of the vested interests in these markets to continue to earn fees from running the market, while transferring the risk of mortgage defaults to U.S. taxpayers.

I recognize, of course, that the U.S. housing and mortgage markets are currently in a highly distressed state, and rapidly closing down the GSEs would be inadvisable. There is, however, a very safe and dependable mechanism to close down the GSEs, namely to reduce the conforming loan limits in a steady sequence. For example, a reduction in the conforming loan limits by $100,000 annually would basically close down the GSEs in 7 years. This also has several additional desirable features:

- The GSE subsidies would remain on the smaller sized mortgages for as long as possible.
- The private market would anticipate the annual opening of each new tier of the market.
- The process could be stopped if it appeared the private markets were not responding.

A very important first step would be to allow the recent temporary increase in the conforming loan limits to expire as scheduled on October 1 of this year.

I also recognize that other researchers and market participants do not share my confidence in the private markets and they have proposed a variety of government guarantee plans to replace the GSEs. The least intrusive of these plans proposes a temporary government program of catastrophe insurance, to allow the markets more time to stabilize, before reverting to a fully private system. As it happens, catastrophe insurance is a second area of my research focus and I am therefore familiar with the successes and failures of the various government insurance programs.

In my opinion, the Terrorism Risk Reinsurance Act (TRIA) is arguably the most successful of all the current government insurance programs. As you may recall, TRIA provides reinsurance against the catastrophic losses that an insurer may suffer from providing terrorism insurance on commercial buildings. It was enacted, following 9/11, to provide insurers with the reinsurance that would allow them to provide building owners coverage against losses from a terrorist attack.

TRIA has been successful in that the private market for terrorism insurance is now active and efficient, with private insurers taking the first-loss position for all events. Furthermore, taxpayer payments arise only for the most extreme events where the insured losses would substantially exceed the insured losses realized from 9/11. If a catastrophe back-stop for the U.S. mortgage market is considered critical, a TRIA-like plan could work well.

Unfortunately, I believe the actual plans for new government mortgage guarantee programs are likely to require the U.S. government itself to take the first-loss position, quite the opposite of providing reinsurance against only catastrophic losses. This is the experience with the National Flood Insurance Program on the federal level and with the California Earthquake Authority and the Florida Hurricane Fund on the state level. While the authorizations for these programs all used the right words--no subsidies, risk-based premium, sound capital, etc.--in practice, they have all proven costly or ineffective. Specifically, you will recall that, following Katrina, the National Flood Insurance Program needed a $20 billion plus federal appropriation to cover its losses. The Florida Hurricane fund is similarly a ward of the state of Florida. The California Earthquake Authority has had the good luck of no major earthquakes, but it also has reached remarkably few customers.

The common problem for these government insurance programs is the inability to maintain premiums at a true actuarial level. Instead, inevitably, the underwriting standards and the premiums are reduced, sooner or later leading to taxpayer costs. I fear a new government mortgage guarantee plan will follow this path, ultimately leading to further taxpayer losses.

Not to end on such a somber note, let me say again I believe that private markets can efficiently provide all the required mortgage market functions, and that steady reductions in the conforming loan limits is a safe and dependable means to make the transition.

Table 1: The Performance of European Mortgage Markets in Comparison with the US (1)

Statistical Measures Computed with annual data by country for the years 1998 to 2009

	(1) Rate of Owner Occupancy 2009	(2) Coefficient of Covariation Housing Starts (2)	(3) Standard Deviation of House Price Inflation	(4) Mortgage Adjustable Rate Average Level	(5) Mortgage Interest Rate Average Spread (3)	(6) Mortgage To GDP Ratio 2009
Western Europe						
Austria	56.2%	6.8%	2.5%	5.00%	1.79%	26.2%
Belgium	78.0%	15.9%	4.1%	5.75%	2.54%	43.3%
Denmark	54.0%	57.4%	8.7%	5.90%	2.46%	103.8%
Finland	59.0%	14.4%	4.0%	4.34%	1.12%	58.0%
France	57.4%	18.2%	6.4%	4.90%	1.69%	38.0%
Germany	43.2%	29.5%	1.7%	5.19%	1.98%	47.6%
Ireland	74.5%	84.2%	13.8%	4.43%	1.07%	90.3%
Italy	80.0%	25.7%	3.1%	4.96%	1.63%	21.7%
Luxembourg	75.0%	19.2%	4.8%	4.26%	1.05%	42.0%
Netherlands	57.2%	12.3%	6.6%	5.13%	1.93%	105.6%
Norway	76.7%	24.3%	5.2%	6.28%	1.43%	70.8%
Portugal	76.0%	27.2%	4.1%	4.91%	1.64%	67.5%
Spain	85.0%	60.5%	7.7%	4.29%	1.03%	64.6%
Sweden	66.3%	61.7%	3.4%	3.83%	0.80%	82.0%
United Kingdom	69.5%	13.9%	7.1%	5.24%	0.75%	87.6%
EU Average	**67.2%**	**31.4%**	**5.6%**	**4.96%**	**1.53%**	**63.3%**
US	**67.2%**	**40.0%**	**7.5%**	**5.16%**	**2.10%**	**81.4%**
US Rank	**8th of 16**	**5th of 16**	**4th of 16**	**6th of 16**	**3rd of 16**	**5th of 16**

Notes:

(1) Unless noted otherwise, the data are all from European Mortgage Federation (2009), an annual fact book that contains comprehensive mortgage and housing market data for the years 1998 to 2009 for 15 Western European countries and the United States.

(2) Computation based on housing starts where available; all other countries use housing permits.

(3) The mortgage interest rate spread equals the mortgage interest rate (column 4) relative to the each country's 3-month Treasury Bill rate; Source OECD Economic Outlook Database.