Testimony of Mark A. Calabria, Ph.D.
Director, Financial Regulation Studies, Cato Institute
Before the
U.S. Senate Committee on Banking, Housing and Urban Affairs
Subcommittee on Housing, Transportation and Community Development
On "New Ideas for Refinancing and Restructuring Mortgage Loans"
September 14, 2011

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Chairman Menendez, Ranking Member DeMint, and distinguished members of the Subcommittee, I thank you for the invitation to appear at today's important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a nonprofit, non-partisan public policy research institute located here in Washington, DC. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official policy positions of the Cato Institute. In addition, outside of my interest as a citizen, homeowner and taxpayer, I have no direct financial interest in the subject matter before the Committee today, nor do I represent any entities that do.

State of the Housing Market

The U.S. housing market remains weak, with both homes sales and construction activity considerably below trend. Despite sustained low mortgage rates, housing activity has remained sluggish in the first half of 2011. Although activity will likely be above 2010 levels, 2011 is expected to fall below 2009 levels and is unlikely to reach levels seen during the boom for a number of years. In fact I believe it will be at least until 2014 until we see construction levels approach those of the boom. As other witnesses are likely to provide their economic forecasts of housing activity, which are generally within the consensus estimates, I will not repeat that exercise here.

Housing permits, on an annualized basis, decreased 3.2 percent from June to July (617,000 to 597,000). While permits for both single family units and smaller multifamily units increased slightly, the overall decline in housing permits was driven by an 11.9 percent decline in permits for larger multifamily properties (5+ units). Single family permits increased from 402,000 to 404,000 in July. Permits for 2-4 unit properties climbed to the highest level of the year (21,000 to 22,000) in July. Permits for 5+ units dropped to 171,000 in July from 194,000 in June.

According to the Census Bureau, July 2011 housing starts were at a seasonally adjusted annual rate of 604,000, down slightly from the June level of 613,000. Overall starts are slightly up, on an annualized level, from 2010's 585,000 units. This increase, however, is completely driven by a jump in multifamily starts, as single-family starts witnessed a significant decline. Total residential starts continue to hover at levels around a third of those witnessed during the bubble years of 2003 to 2004.

As in any market, prices and quantities sold in the housing market are driven by the fundamentals of supply and demand. The housing market faces a significant oversupply of housing, which will continue to weigh on both prices and construction activity. The Federal Reserve Bank of New York estimates that oversupply to be approximately 3 million units. Given that annual single family starts averaged about 1.3 million over the last decade, it should be clear that despite the historically low current level of housing starts, we still face a glut of housing. NAHB estimates that about 2 million of this glut is the result of "pent-up" demand, leaving at least a million units in excess of potential demand[i]. Add to that another 1.6 million mortgages that are at least 90 days late. My rough estimate is about a fourth of those are more than two years late and will most likely never become current.

The nation's oversupply of housing is usefully documented in the Census Bureau's Housing Vacancy Survey. The boom and bust of our housing market has increased the number of vacant housing units from 15.6 million in 2005 to a current level of 18.7 million. The rental vacancy rate for the 2nd quarter of 2011 declined considerably to 9.2 percent, although this remains considerably above the historic average. The decline in rental vacancy rates over the past year has been driven largely by declines in suburban rental markets. Vacancy rates for both rental and homeowner units remain considerably higher for new construction relative to existing units.

The homeowner vacancy rate, after increasing from the 2nd and 3rd quarters of 2010 to the 4th quarter of 2010, declined to 2.5 percent in the 2nd quarter of 2011, a number still in considerable excess of the historic average.

The homeowner vacancy rate, one of the more useful gauges of excess supply, differs dramatically across metro areas. At one extreme, Orlando has an owner vacancy rate approaching 6 percent, whereas Allentown, PA has a rate of 0.5 percent. Other metro with excessive high owner vacancy rates include: Toledo OH (5.5), Las Vegas (5.1), Raleigh, NC (5.0), Riverside CA and Jacksonville FL. Relatively tight owner markets include: Springfield MA (0.7), San Jose CA (0.9), and Honolulu HI (1.0).

The number of vacant for sale or rent units has increased, on net, by around 1 million units from 2005 to 2011. Of equal concern is that the number of vacant units "held off the market" has increased by about 1.5 million since 2005. In all likelihood, many of these units will re-enter the market once prices stabilize.

The 2nd quarter 2011 national homeownership rate fell to 65.9 percent, the first time it broken the floor of 66 percent since 1997, effectively eliminating all the gain in the homeownership rate over the last 12 years. Declines in the homeownership rate were the most dramatic for the youngest homeowners, while homeownership rates for those 55 and over were stable or saw only minor declines. This should not be surprising given that the largest increase in homeownership rates was among the younger households and that such households have less attachment to the labor market than older households. Interestingly enough, the percentage point decline in homeownership was higher among households with incomes above the median than for households with incomes below the median.

While homeownership rates declined across the all Census Regions, the steepest decline was in the West, followed by the Northeast. The South witnessed the smallest decline in homeownership since the bursting of the housing bubble.

Homeowner vacancy rates differ dramatically by type of structure, although all structure types exhibit rates considerably above historic trend levels. For 2nd quarter 2011, single-family detached homes displayed an owner vacancy rate of 2.2 percent, while owner units in buildings with 10 or more units (generally condos or co-ops) displayed an owner vacancy rate of 8.7 percent. Although single-family detached constitute 95 percent of owner vacancies, condos and co-ops have been impacted disproportionately. Interestingly enough, over the last year homeowner vacancy rates have been stable for single-family structures, but have declined, albeit from a much higher level.

Owner vacancy rates tend to decrease as the price of the home increases. For homes valued under $150,000 the owner vacancy rate is 3.1 percent, whereas homes valued over $200,000 display vacancy rates of about 1.4 percent. The vast majority, almost 75%, of vacant owner-occupied homes are valued at $300,000 or less. Owner vacancy rates are also the highest for the newest homes, with new construction displaying vacancy rates twice the level observed on older homes.

While house prices have fallen considerably since the market's peak in 2006 – over 23% if one excludes distressed sales, and about 31% including all sales – housing in many parts of the country remains expensive, relative to income. At the risk of oversimplification, in the long run, the size of the housing stock is driven primarily by demographics (number of households, family size, etc), while house prices are driven primarily by incomes. Due to both consumer preferences and underwriting standards, house prices have tended to fluctuate at a level where median prices are approximately 3 times median household incomes. Existing home prices, at the national level, are close to this multiple. In several metro areas, however, prices remain quite high relative to income. For instance, in San Francisco, existing home prices are almost 8 times median metro incomes. Despite sizeable decline, prices in coastal California are still out of reach for many families. Prices in Florida cities are generally above 4 times income, indicating they remain just above long-run fundamentals. In some bubble areas, such as Phoenix and Las Vegas, prices are below 3, indicating that prices are close to fundamentals. Part of these geographic differences is driven by the uneven impact of federal policies.

Household incomes place a general ceiling on long-run housing prices. Production costs set a floor on the price of new homes. As Professors Edward Glaeser and Joseph Gyourko have demonstrated[ii], housing prices have closely tracked production costs, including a reasonable return for the builder, over time. In fact the trend has generally been for prices to about equal production costs. In older cities, with declining populations, productions costs are often in excess of replacement costs. After 2002, this relationship broken down, as prices soared in relation to costs, which also included the cost of land[iii]. As prices, in many areas, remain considerably above production costs, there is little reason to believe that new home prices will not decline further.

It is worth noting that existing home sales in 2010 were only 5 percent below their 2007 levels, while new home sales are almost 60 percent below their 2007 level. To a large degree, new and existing homes are substitutes and compete against each other in the market. Perhaps the primary reason that existing sales have recovered faster than new, is that price declines in the existing market have been larger. Again excluding distressed sales, existing home prices have declined 23 percent, whereas new home prices have only declined only about 10 percent. I believe this is clear evidence that the housing market works just like other markets: the way to clear excess supply is to reduce prices.

State of the Mortgage Market

According to the Mortgage Bankers Association's National Delinquency Survey, the delinquency rate for mortgage loans on one-to-four-unit residential properties increased to a seasonally adjusted rate of 8.44 percent of all loans outstanding for the end of the 2nd quarter 2011, 12 basis points up from 1st quarter 2011, but down 141 basis points from one year ago.

The percentage of mortgages on which foreclosure proceedings were initiated during the second quarter was 0.96 percent, 12 basis points down from 2001 Q1 and down 15 basis points from 2010 Q2. The percentage of loans in the foreclosure process at the end of the 2nd quarter was 4.43 percent, down slightly at 9 basis points from 2011 Q1 and 14 basis points lower than 2010 Q2. The serious delinquency rate, the percentage of loans that are 90 days or more past due or in the process of foreclosure, was 7.85 percent, a decrease of 25 basis points from 2011 Q1, and a decrease of 126 basis points from 2010 Q2.

The combined percentage of loans in foreclosure or at least one payment past due was 12.54 percent on a non-seasonally adjusted basis, a 23 basis point increase from 2011 Q1, but was 143 basis points lower than 2010 Q2.

Mortgage Policies

For those who can get a mortgage, rates remain near historic lows. These lows rates, however, are not completely the outcome of the market, but are driven, to a large degree, by federal policy interventions. Foremost among these interventions is the Federal Reserve's current monetary policy. Of equal importance is the transfer of almost all credit risk from market participants to the federal taxpayer, via FHA and the GSEs. Given massive federal deficits as far as the eye can see, and the already significant cost of rescuing Fannie Mae and Freddie Mac, policymakers should be gravely concerned about the risks posed by the current situation in our mortgage markets. Immediate efforts should be made to reduce the exposure of the taxpayer.

In transitioning from a government-dominated to market-driven mortgage system, we face the choice of either a gradual transition or a sudden “big bang”. While I am comfortable with believing that the remainder of the financial services industry could quickly assume the functions of Fannie Mae and Freddie Mac, I recognize this is a minority viewpoint. Practical politics and concern as to the state of the housing market point toward a gradual transition. The question is then, what form should this transition take? One element of this transition should be a gradual, step-wise reduction in the maximum loan limits for the GSEs (and FHA).

If one assumes that higher income households are better able to bear increases in their mortgage costs, and that income and mortgage levels are positively correlated, then reducing the size of the GSEs’ footprint via loan limit reductions would allow those households best able to bear this increase to do so. As tax burden and income are also positively correlated, the reduction in potential tax liability from a reduction in loan limits should accrue to the very households benefited most by such a reduction.

Moving beyond issues of “fairness” – in terms of who should be most impacted by a transition away from the GSEs – is the issue of capacity. According to the most recent HMDA data (2009), the size of the current jumbo market (above $729k) is approximately $90 billion. Reducing the loan limit to $500,000 would increase the size of the jumbo market to around $180 billion. Since insured depositories have excess reserves of over $1 trillion, and an aggregate equity to asset ratio of over 11 percent, it would seem that insured depositories would have no trouble absorbing a major increase in the jumbo market.

Given that the Mortgage Banker Association projects total residential mortgage originations in 2011 to be just under $1 trillion, it would appear that insured depositories could support all new mortgages expected to be made in 2011 with just their current excess cash holdings. While such an expansion of lending would require capital of around $40 billion, if one is to believe the FDIC, then insured depositories already hold sufficient excess capital to meet all new mortgage lending in 2011.

Moving more of the mortgage sector to banks and thrifts would also insure that there is at least *some* capital behind our mortgage market. With Fannie, Freddie and FHA bearing most of the credit risk in our mortgage market, there is almost no capital standing between these entities and the taxpayer.

The bottom line is that reducing the conforming loan limit to no more than $500,000, if not going immediately back to $417,000, would represent a fair, equitable and feasible method for transitioning to a more private-sector driven mortgage system. Going forward, the loan limit should be set to fall by $50,000 each year. As this change could be easily reversed, it also represents a relatively safe choice.

Reducing the competitive advantage of Fannie Mae and Freddie Mac via a mandated increase in their guarantee fees would both help to raise revenues while also helping to "level the playing field" in the mortgage market. Given that the federal taxpayer is covering their losses and backing their debt, along with the suspension of their capital requirements, no private entity can compete with Fannie Mae and Freddie Mac. We will never be able to move to a more private market approach without reducing, if not outright removing, these taxpayer-funded advantages.

An increase in the GSE guarantee fee could also be used to re-coup some of the taxpayer "investment" in Fannie Mae and Freddie Mac. Section 134 of the Emergency Economic Stabilization Act of 2008, better known as the TARP, directed the President to submit a plan to Congress for recoupment for any shortfalls experienced under the TARP. Unfortunately the Housing and Economic Recovery Act of 2008, which provided for federal assistance to the GSEs, lacked a similar requirement. Now is the time to rectify that oversight. Rather than waiting for a Presidential recommendation, Congress should establish a recoupment fee on all mortgages purchased by Fannie Mae and Freddie Mac. Such a fee would be used directly to reduce the deficit and be structured to recoup as much of the losses as possible. I would recommend that the recoupment period be no longer than 15 years and should begin immediately. A reasonable starting point would be 1 percentage point per unpaid principal balance of loans purchased. Such as sum should raise at least $5 billion annually and should be considered as only a floor for the recoupment fee.

In any discussion regarding costs in our mortgage market, we must never forget that homeowners and homebuyers are also taxpayers. Using either current taxes or future taxes (via deficits) to fund subsidies in the housing market reduces household disposable income, which also reduces the demand for housing. None of the subsidies provided to the housing and mortgage markets are free. They come at great costs, which should be included in any evaluation of said subsidies.

Contribution of Federal Policy

Federal government interventions to increase house prices, including Federal Reserve monetary and asset purchases, have almost exclusively relied upon increasing the demand for housing. The problem with these interventions is they have almost the opposite impact between markets where supply remains tight and those markets with a housing glut. In areas where housing supply is inelastic, that is relatively unresponsive (often the result of land use policies), these programs have indeed slowed price declines. Areas where supply is elastic, where building is relatively easy, have instead seen an increase in supply, rather than price. For these areas the increase in housing supply will ultimately depress prices even further.

A comparison of San Diego, CA and Phoenix, AZ illustrates the point. Both are of similar population (2.5 million for Sand Diego, 2.2 million for Phoenix), and both witnessed large price increases during the bubble. Yet the same federal policies have drawn different supply and price responses. In 2010, about 8,200 building permits were issued for the greater Phoenix area; whereas only about 3,500 were issued for San Diego. Existing home prices (2010) in Phoenix fell over 8%, whereas prices in San Diego actually grew by 0.6%. This trend is compounded by the fact that prices are almost three times higher in San Diego than in Phoenix. The point is that federal efforts to “revive” the housing market are sustaining prices in the most expensive markets, while depressing prices in the cheapest markets, the opposite of what one would prefer. As home prices are correlated positively with incomes, these policies represent a massive regressive transfer of wealth from poorer families to richer.

Among policy interventions, the Federal Reserve’s interest rates policies are perhaps having the worst impact. It is well accepted in the urban economics and real estate literature that house prices decline as distances from the urban core increase. It is also well accepted that the relative price of urban versus suburban house prices is influenced by transportation costs. For instance, an increase in the price of gas, will, all else equal, lower the price of suburban homes relative to urban. If loose monetary policy adds to increases in fuel prices, which I believe it has, then such monetary policies would result in a decline in suburban home prices relatives to urban. One can see this dynamic play out in California. In general, prices in central cities and urban cores, have witnessed only minor declines or actual increases over the last year. According to the California Association of Realtors, overall state prices are down just 2% from January 2010 to January 2011. Yet prices in the inland commuting counties – Mariposa (-27%), San Benito (-14%), Butte (-29%), Kings (-16%), Tulare (-16%) – are witnessing the largest declines, in part driven by increases in commuting (gas) costs.

Foreclosure Mitigation and the Labor Market

There is perhaps no more important economic indicator than unemployment. The adverse impacts of long-term unemployment are well known, and need not be repeated here. Although there is considerable, if not complete, agreement among economists as to the adverse consequences of jobless; there is far less agreement as to the causes of the currently high level of unemployment. To simplify, the differing explanations, and resulting policy prescriptions, regarding the current level of unemployment fall into two categories: 1) unemployment as a result of lack of aggregate demand, and 2) unemployment as the result of structural factors, such as skills mismatch or perverse incentives facing the unemployed. As will be discussed below, I believe the current foreclosures mitigation programs have contributed to the elevated unemployment rate by reducing labor mobility. The current foreclosures mitigation programs have also helped keep housing prices above market-clearing levels, delaying a full correction in the housing market.

First we must recognize something unusual is taking place in our labor market. If the cause of unemployment was solely driven by a lack of demand, then the unemployment rate would be considerably lower. Both GDP and consumption, as measured by personal expenditures, have returned to and now exceed their pre-crisis levels. But employment has not. Quite simply, the “collapse” in demand is behind us and has been so for quite some time. What has occurred is that the historical relationship between GDP and employment (which economists call “Okun’s Law) has broken down, questioning the ability of further increases in spending to reduce the unemployment rate. Also indicative of structural changes in the labor market is the breakdown in the “Beveridge curve” – that is the relationship between unemployment and job vacancies. Contrary to popular perception, job postings have been steadily increasing over the last year, but with little impact on the unemployment rate.

Historically many job openings have been filled by workers moving from areas of the country with little job creation to areas with greater job creation. American history has often seen large migrations during times of economic distress. And while these moves have been painful and difficult for the families involved, these same moves have been essential for helping the economy recover. One of the more interesting facets of the recent recession has been a decline in mobility, particular among homeowners, rather than an increase. Between 2008 and 2009, the most recent Census data available, 12.5 percent of households moved, with only 1.6 moving across state lines. Corresponding figures for homeowners is 5.2 percent and 0.8 percent moving across state lines. This is considerably below interstate mobility trends witnessed during the housing boom. For instance from 2004 to 2005, 1.5% of homeowners moved across state lines, almost double the current percentage. Interestingly enough the overall mobility of renters has barely changed from the peak of the housing bubble to today. This trend is a reversal from that witnessed after the previous housing boom of the late 1980s burst. From the peak of the bubble in 1989 to the bottom of the market in 1994, the percentage of homeowners moving across state lines actually increased.

The preceding is not meant to suggest that all of the declines in labor mobility, or increase in unemployment, is due to the foreclosure mitigation programs. Far from it. Given the many factors at work, including the unsustainable rate of homeownership, going into the crisis, it is difficult, if not impossible, to estimate the exact contribution of the varying factors. We should, however, reject policies that encourage homeowners to remain in stagnant or declining labor markets. This is particularly important given the fact that unemployment is the primary driver of mortgage delinquency.

Conclusion

The U.S. housing market is weak and is expected to remain so for some time. Given the importance of housing in our economy, the pressure for policymakers to act has been understandable. Policy should, however, be based upon fostering an unwinding of previous unbalances in our housing markets, not sustaining said unbalances. We cannot go back to 2006, and nor should we desire to. As the size and composition of the housing stock are ultimately determined by demographics, something which policymakers have little influence over in the short run, the housing stock must be allowed to align itself with those underlying fundamentals. Prices should also be allowed to move towards their long run relationship with household incomes. Getting families into homes they could not afford was a major contributor to the housing bubble. We should not seek to repeat that error. We must also recognize that prolonging the correction of the housing market makes the ultimate adjustment worse, not better. Lastly it should be remembered that one effect of boosting prices above their market-clearing levels is the transfer of wealth from potential buyers (renters) to existing owners. As existing owners are, on average, wealthier than renters, this redistribution is clearly regressive.

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[i] Denk, Dietz and Crowe. Pent-up Housing Demand: The Household Formations That Didn't Happen – Yet. National Association of Home Builders. February 2011.
[ii] Edward Glaeser and Gyourko, Joseph, "The Case Against Housing Price Supports," *Economists' Voice* October 2008.
[iii] Also see Robert Shiller, "Unlearned lessons from the housing bubble," *Economists' Voice* July 2009.