Testimony of

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Housing Finance in International Perspective

Mr. Chairman, Ranking Member Corker, and Members of the Subcommittee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI, I was the President and CEO of the Federal Home Loan Bank of Chicago from 1991 to 2004. From 1999 to 2001, I also served as President of the International Union for Housing Finance, a trade association devoted to the international exchange of housing finance ideas and practices, and continue to be a member of its Executive Committee.

A Middle of the Pack Home Ownership Rate, GSEs Notwithstanding

As we begin the last quarter of 2010, our housing finance system (as well as those of some other countries) is still struggling in the wake of the great housing bubble of 2000-06 and its collapse into the panic and serial crises of 2007-09.

Housing finance cannot be considered apart from its effects on house prices. When you push a lot of credit at an asset class, its price tends to rise. American housing finance practices and subsidies helped inflate house prices during the bubble. Then U.S. average house prices fell by more than 30% from peak to trough-- something, we must remember, which was previously considered impossible. This brought them back to their long-term trend line and to the levels of 2003, with all of the losses and turmoil with which we are so familiar. A memorable decade! One of its lessons is to try to remember that things considered impossible can nonetheless happen.

As we develop other lessons for the next decade, there is no doubt that it is educational and useful to examine American housing finance in international perspective.

Comparing our housing finance system to other countries, we discover that one thing remarkable and indeed unique in the world about American housing finance was the dominant and disproportionate role played by government-sponsored enterprises, namely Fannie Mae and Freddie Mac, wielding their “implied” government guaranty. Based on this “implied” guaranty, massive amounts of their debt securities were sold around the world, so that foreign institutions could help inflate U.S. house prices without worrying about the risk and later be bailed out as creditors by American taxpayers. Of course the “implied” guaranty always was a *real* U.S. government guaranty, as events have amply demonstrated, but it did not have to be accounted for as one.

In the days of Fannie and Freddie’s pride, their representatives and political supporters used frequently to say, “American housing finance is the envy of the world!” It really wasn’t, at least based on my discussions with housing finance colleagues from other countries. But many Americans--including members of Congress-- thought it was, just as they mistakenly thought and said that the U.S. had the highest home ownership rate in the world. We didn’t and don’t.

This is apparent from the table of Comparative Home Ownership Rates on page 3. The U.S. ranks 17th of 26 economically advanced countries, or about two-thirds of the way down the list.

I think we can agree that we would like our society to have a property-owning democratic citizenry, which includes widespread home ownership. But the international perspective makes it clear that many countries achieve home ownership levels as high or higher than ours with no GSEs. It turns out that these levels can be achieved without tax deductions for the interest paid on home mortgages, without our very unusual practice of making mortgages into non-recourse debt, without government mandates to make “creative” (that is, riskier) loans, without 30-year fixed-rate loans, and with prepayment fees on mortgages. Of course, as bubbles and busts in other countries show, you can also get in trouble with different systems.

At a minimum, we should never assume that the particular historical development so far of the U.S. housing finance system is definitive.

Canada

The better credit performance of Canadian housing finance over the last several years has become well known. The proportion of Canadian mortgage loans more than 90 days delinquent in the first quarter, 2010 was less than ½%. This is about one-tenth the ratio of U.S. mortgages over 90 days delinquent at that time, which was 4.9%. If we add to the U.S. number mortgage loans in foreclosure to look at serious delinquencies, it jumps to 9.5%. Quite a contrast, as many people have remarked.

Comparative Home Ownership Rates

Rank	Country	Ownership Rate	Date	Source
1	Singapore	89%	2009	Statistics Singapore
2	Spain	85%	2008	European Mortgage Federation
3	Iceland	83%	2005	Statistics Iceland (HES survey)
4	Belgium	78%	2007	European Mortgage Federation
5	Norway	77%	2001	UN Economic Commission for Europe
6	Portugal	76%	2007	European Mortgage Federation
7	Luxembourg	75%	2008	European Mortgage Federation
8	Ireland	75%	2009	European Mortgage Federation
9	Chile	73%	2002	UN Housing Policy
10	Italy	72%	2007	INSEE and Eurostat
11	Israel	71%	2004	UN Economic Commission for Europe
12	Australia	70%	2006	Australian Bureau of Statistics
13	England	68%	2010	Building Societies Association
14	Canada	68%	2006	Statistics Canada
15	Sweden	68%	2008	European Mortgage Federation
16	New Zealand	68%	2001	Statistics New Zealand
17	UNITED STATES	67%	2009	US Census Bureau
18	Japan	61%	2003	Japan Statistical Yearbook 2005
19	Finland	59%	2008	Statistics Finland
20	Czech Republic	59%	2007	European Mortgage Federation
21	France	57%	2007	European Mortgage Federation
22	Netherlands	57%	2008	European Mortgage Federation
23	Austria	56%	2009	Statistics Austria
24	Denmark	54%	2009	European Mortgage Federation
25	Germany	46%	2007	INSEE and Eurostat
26	Switzerland	35%	2000	Statistics Switzerland

Canada makes a pertinent comparison for the U.S. It is in population and economic size much smaller, of course—about one-tenth in both cases—but is in many ways very similar.

Both countries are rich, advanced, democratic, and stable, have sophisticated financial systems and pioneer histories, and stretch from Atlantic to Pacific. But Canada has no housing GSEs; mortgage loan interest is not tax deductible; it does not have 30-year fixed rate mortgages; it does have prepayment fees.

Mortgage lending is more conservative and creditor-friendly. Canadian mortgage lenders have full recourse to the borrower's other assets and income, in addition to the security interest in the house. This means there is less incentive for underwater borrowers to "walk away" from their house and mortgage. No tax deduction for interest probably increases the incentive to pay down debt. Most Canadian mortgage payments are made through automatic debit of the borrower's checking account and can be matched to paycheck frequency—a technical but important behavioral point. Canadian fixed rate mortgages typically are fixed for only up to five years. Subprime mortgages were a much smaller part of the market.

This relative conservatism has meant that Canadian banks, the principal mortgage lenders, while experiencing some pressure, have come through the international financial crisis in much better shape than their U.S. counterparts, with (as observed above) mortgage delinquencies so far well-behaved.

There does not appear to have been a home ownership price to pay for this relative credit conservatism. Canada's home ownership rate is 68% vs. 67% for the U.S. Two very different housing finance systems, one, as it turned out, much riskier than the other, produced virtually the same home ownership rate.

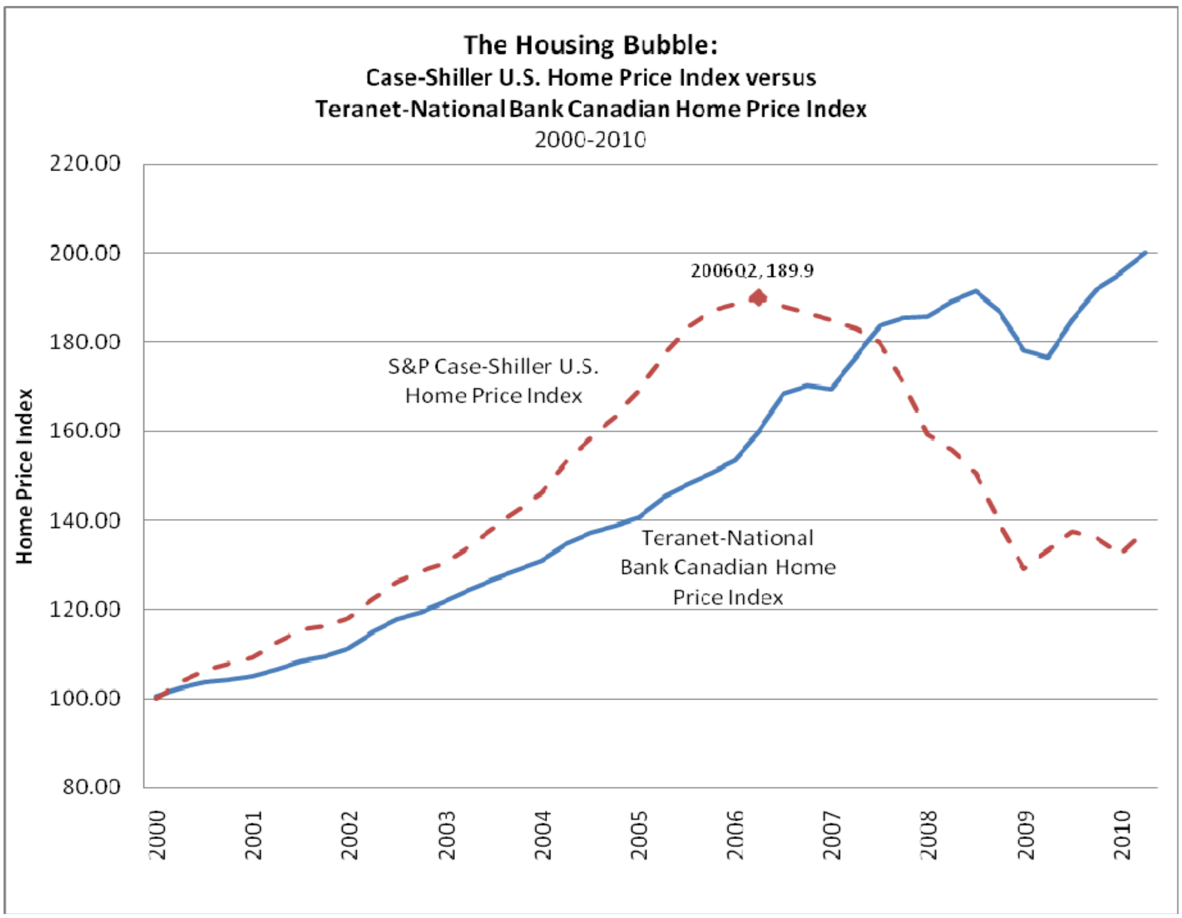
It is important to recognize that Canada does have an important government body to promote housing finance, which has a substantial role: the Canada Mortgage and Housing Corporation (CMHC). Among its principal activities is insuring (guaranteeing) mortgage loans, another is securitizing some of the insured loans. So you could think of it in one sense as a combination of FHA and Ginnie Mae. (Its mortgage insurance program was originally modeled on the FHA in 1954.)

CMHC's mortgage insurance is a major factor in the market, covering about C$470 billion out of total mortgage debt of about C$ 950 billion, or roughly half of Canadian mortgages. This is the same proportion as the combined Fannie and Freddie in the U.S. (over $5 trillion out of about $10 trillion).

Whether or not you like the idea of such a scale of government financing, you have to say that, in contrast to the American GSEs, at least CMHC's status is completely clear and honest. It is a 100% government-owned and controlled corporation. Its government guaranty is explicit, so it operates with the formal full faith and credit of the government of Canada. It also provides housing subsidies which are on budget and must be appropriated by Parliament.

Canada in this respect looks superior to the U.S. in candor, as well as credit performance.

However, CMHC does obviously represent a large government intervention in the housing finance market. Recalling our previous point about the interaction of housing finance and house prices, one Canadian criticism is that this intervention has caused excessive inflation in Canadian house prices. Indeed, Canadian house prices measured relative to a base of the year 2000, have now risen higher than U.S. relative house prices at the top of the bubble, as shown in the following graph.



A general rule is that as long as house prices are rising, mortgage loan performance will be good. Some Canadian commentators worry about whether their house prices are in a bubble. The Fraser Institute, a Canadian free-market think tank, has called the Canadian mortgage system "a high taxpayer-vulnerability model."

In response to these worries, Canadian regulators have taken important countercyclical actions to lower the maximum loan-to-value (LTV) ratios on some of the riskier classes of mortgage loans. In other words, they now require larger down payments and allow less leverage of the properties. Such countercyclical movement in LTV limits, in my opinion, is an excellent idea and necessary to moderate the inevitable cycles in real estate credit. We should stay tuned to the highly interesting Canadian housing finance story.

Matching Mortgage Assets and Mortgage Funding

The traditional and still typical Canadian mortgage has a long-term amortization schedule (up to 35 years for CMHC-insured mortgages), but with an interest rate fixed for five years, after which the interest rate is re-set for another five years, and so on. Shorter fixed periods are also common, but the debt service to income ratios are to be approved based on the prevailing five-year rate.

About two-thirds of mortgages remain on the balance sheet of the lenders, which are dominated by five nationwide banks. The five-year fixed rate mortgage loans are often funded by the issuance of five-year fixed rate certificates of deposit, which gives a very good natural matching (that is, no derivatives required) of the banks' assets and liabilities. Obviously, such matching is also available for shorter fixed rate periods.

This is a straightforward answer to a fundamental problem of every housing finance system: how to match the nature of the mortgage asset with an appropriate funding source, so that you are not lending long and borrowing short. Different approaches distribute the risks among the parties involved, including lenders, investors, guarantors, borrowers and the government, in various ways. The classic example of not achieving the needed match is the infamous collapse of the American savings and loan industry in the 1980s.

There are clearly some basic variations:

-Variable rate mortgages funded with short-term deposits

-Medium-term fixed rate mortgages funded with medium-term fixed rate deposits or bonds

-Long-term fixed rate mortgages funded with long-term fixed rate bonds or mortgage-backed securities.

In general, variable rate mortgages put the risk of rising interest rates in the first place on the borrowers. To have long-term fixed rate mortgages requires funding by some form of access to the long-term bond market. Every housing finance system must address this fundamental asset-liability question; the answer results in a particular distribution of risks.

Denmark

The most perfect solution in theory, which also functions very well practically in its national setting in an admittedly small country, is that of the housing finance system of Denmark. It has been admired by many observers. Explicitly governed by what it calls the "matching principle," the interest rate and prepayment characteristics of the mortgage loans being funded, which include long-term fixed rate loans, are passed entirely on to the investor in Danish mortgage bonds.

At the same time, there is a total "skin in the game" requirement for retention of credit risk by the mortgage lenders. The mortgage banks retain 100% of the credit risk of the loans, in exchange for an annual fee, thus insuring alignment of incentives for credit performance. Deficiency judgments, if foreclosure on a house does not cover the mortgage debt, are actively pursued.

The fundamentals of the Danish mortgage system go back over 200 years. There are no GSEs or government housing banks. This is a private housing finance system built on what appear to be quite robust principles. It generates a home ownership rate of 54%, below that of Canada or the U.S.

Some years ago, when the proud hearts of Fannie and Freddie had not yet had their fall, I participated in an exchange with the Association of Danish Mortgage Banks. They explained their mortgage bond- and skin in the game-based system to me, then I explained the American GSE-centric mortgage system to them.

When I was done, the CEO of one of the leading Danish mortgage banks said this: "In Denmark we always say that we are the socialists and America is the land of free enterprise. Now I see that when it comes to mortgage finance, it is the opposite!"

England

England has a large economy, is financially very sophisticated, and has an entirely different housing finance structure. It also has no GSEs. The traditional and still typical English mortgage is a variable-rate loan financed by deposits in banks or mutual building societies. The interest rate on these loans can be changed up or down at the will of the lender, so everybody's rate changes at the same time. This is a natural asset-liability matching for the depository institutions, but is risky for the borrowers.

England had a housing boom and bust in the 21st century cycle, as we did. Indeed, the first casualty of the financial panic was an English mortgage lender, Northern Rock, which was a well-known securitizer of mortgages. Northern Rock failed in 2007, long before Bear Stearns did, when the wholesale investing market refused to continue investing. This was followed by first a run on its retail deposits, then by the nationalization of the bank.

England also had a unified financial regulator, the Financial Services Authority, whose jurisdiction included mortgage lenders as well as all other financial intermediaries. This unified regulatory structure did not avoid the crisis.

Still, England has a home ownership rate of 68%, just ahead of the U.S.

Germany

Some German banks got into serious trouble in the housing bubble, but by investing in U.S. mortgage securities and other foreign mortgages, not in their domestic mortgage lending market, which is quite conservative. It generates a home ownership rate of 46%, which would not be politically acceptable in an American setting.

Nevertheless, there are two German housing finance ideas worthy of study. One is its mortgage covered bond ("Pfandbrief"). With a statutory basis more than one hundred years old (and it is claimed, a history going back to Frederick the Great of Prussia), the covered bond has provided a relatively stable source of bond-based mortgage financing.

Covered bonds allow a fixed rate funding for fixed rate mortgage loans, and keep the credit incentives of the lender intact, since the lender remains responsible for 100% of the credit risk and the loans stay on its balance sheet. But they provide access to the bond market, in addition to deposit-based funding, and are indeed a major component of the German bond market. The mortgage loans serve as collateral for the bonds, which are also senior obligations of the issuing mortgage lender.

Many people have proposed, and I agree, that the U.S. should introduce covered bonds as a mortgage funding alternative—one which does not involve a government guaranty. The German experience suggests these lessons:

-There needs to be a statutory basis for these bonds, not merely a regulatory one, to insure the bond holders' rights to the collateral are truly protected.

-The mortgage loans serving as collateral for them (the "cover pool") should be subject to conservative credit standards, to reduce the volatility and uncertainty of their credit behavior.

A second German housing finance idea for consideration is emphasizing (we should say, rediscovering the needed emphasis) on savings as part of sound housing finance. Thus, the German building and savings banks ("Bausparkassen") continue to practice the traditional "savings contract," by which the borrower commits to a regular savings program as part of qualifying for a mortgage loan.

I am not recommending their specific program, but the general principle. We have completely lost the emphasis on savings as part of housing finance. We need to rediscover it.

Switzerland

Switzerland may just be mentioned as a case of the variety exhibited by housing finance in international perspective. It is a wealthy country with a very large and sophisticated financial sector. It has mortgage debt outstanding of about 100% of GDP, somewhat higher than in the U.S.

Yet Switzerland has a home ownership ratio of only 35%, the lowest on our list.

It is an unusual housing finance example. So is the American GSE-centric system, which has collapsed at heavy taxpayer expense, as did the American savings and loan system which preceded it.

Conclusion

The variety of international experience suggests that there is every reason to think broadly and openly about the possibilities for developing a better, post-GSE U.S. housing finance system for the future.

Thank you again for the opportunity to share these views.