“Stabilizing the Housing Market”

Testimony prepared for

HEARING TITLED

“OVERSIGHT OF THE EMERGENCY ECONOMIC STABILIZATION ACT: EXAMINING FINANCIAL INSTITUTION USE OF FUNDING UNDER THE CAPITAL PURCHASE PROGRAM”

ON

NOVEMBER 13, 2008,

BEFORE

THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,

U.S. SENATE

WRITTEN TESTIMONY OF DR. SUSAN M. WACHTER
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I: Introduction

Chairman Dodd, Ranking Member Shelby, and other distinguished members of the Committee:

Thank you for the invitation to testify at today’s hearing on “Oversight of the Emergency Economic Stabilization Act: Examining Financial Institution Use of Funding Under the Capital Purchase Program.” It is my honor to be here today to provide my perspective on the ongoing mortgage crisis along with how and why stabilizing the housing market is essential to stabilizing the broader U.S. economy. In particular I will address how stabilizing the housing sector can promote growth in the broader economy and the importance of efforts to insure that loan modifications are available to borrowers facing foreclosure. My testimony is based

on studies that I and others have authored on the causes and consequences of the credit crisis.

II: Deflating Housing Market Bubble

The ongoing crisis in our housing and financial markets derives from an expansion of credit through poorly underwritten and overly risky mortgage lending. Interest only loans, sub-prime loans, negative amortization loans, low or zero-equity loans, and teaser-rate adjustable rate mortgages (ARMs), all funded through secondary markets, became increasingly prevalent in the U.S. after 2003 and today account for over half of all foreclosures. Early in the 1990 decade, nonprime lending was insignificant; by 2006 non-prime lending constituted 47% of mortgage originations. The unprecedented expansion of poorly underwritten credit induced and supported a U.S. housing asset bubble beginning in 2003 of similarly unprecedented dimensions. Worldwide, low interest rates were associated with global house price inflation beginning in 2000. Nonetheless, since 2003, housing value increases in the U.S. departed from and exceeded those of our global peers due to a massive erosion of underwriting standards in the U.S. This weakening of lending standards, coupled with increased production, resulted in mortgages which were structured to fail, even in the absence of intent or fraud. However, fraudulent lending also did increase. Eventually, this process became unsustainable, price increases halted, and the poorly underwritten loans could not be rescued by high and ever increasing prices. This led to today's system breakdown.

The result, as we have seen, has been the massive failure of these loans. By the second half of this year delinquencies reached a postwar historic high of 6.41%, and 2 million foreclosures are expected within the next two years. Recent data released by the Mortgage Bankers Association reveals that in the second quarter of 2008, 6.3% of the adjustable rate mortgages extended to subprime borrowers started the foreclosure process, up 61 basis points from the first quarter of 2008. The 90 day delinquency rate for these mortgages was higher than 20%. For prime loans, the foreclosure inventory rate increased 20 basis points to 1.42%, and increased 107 basis points for subprime loans to 11.81%.

The economic downturn could become ever more severe due to the interaction of financial market stress with declines in house prices and a worsening economy all feeding back into an adverse loop; we have the potential for a true economic disaster. In particular, let us remind ourselves that that the problem came from housing. Even with the efforts to solve our banking liquidity problems, we will not solve the prevailing problem if the housing downturn continues and the housing market decline shows no sign of abating. Moreover, despite bank recapitalization and rescue efforts, economically rational loan modifications that would help stabilize the market are not occurring. We must directly address the need for economically rational loan modifications and the barriers to them in order to halt the downward spiral in mortgage markets and the economy.

III: Housing Market Overcorrection

It is critical to bring stability to the housing market. And while prices today may not be far from fundamental levels, just as they overinflated going up, housing prices appear to be in process of overcorrecting on the downside. Can we rely on market forces and the interventions to date to equilibrate housing markets? As prices decrease in a market downturn, the result is that supply declines, demand increases, and markets clear. However, in our current situation, as prices fall, market dynamics give rise to further expectations of price declines limiting demand and supply actually increases due to increased foreclosures. All of these factors cause prices to decline further. A deflationary environment with demand decreases due to expectations of further price decline was in part responsible for Japan's "lost decade" of the 1990s.

We cannot rely on a price decrease floor at currently market-justified fundamental levels if we rely on market forces alone, even if augmented by the aggressive interventions of the Federal Reserve and Treasury to date. In fact, 2008 home inventories are higher than last year. Even though new construction is now limited, foreclosed homes have come onto the market putting upward pressure on supply. In some markets where predatory lending was most prominent, up to half of the inventory of homes are being sold through foreclosures at fire sale prices increasing supply and weighing down prices. The Case-Shiller National House Price Index reflects this massive deterioration of housing wealth as well. Since their peak in 2006, housing values have fallen over 20% so far. While another 10% fall brings

the index to 2003 levels, price declines may far exceed this decline, projected by the Federal Reserve Board and others, as the price decline itself undermines consumer confidence, decreases household wealth, and worsens the system wide financial stress.

While banks have been recapitalized through the Capital Purchase program there is discussion of the use this funding for acquisitions and as yet little evidence that bank lending has expanded. In order for the overall economy to recover and for conditions not to worsen, prudent lending to credit worthy borrowers needs to occur. Without financing for everyday needs, for education, small business investment and health, American families are at risk. And today the US economy and the global economy are depending on the stabilization of their financial well being.

Clearly markets fail. A number of plans have been put in place by the current administration to address the banking crisis. However, these plans do not appear to be leading to the modification of loans at the scale necessary in order to assure a market turnaround at fundamental levels instead of a severe overcorrection. Loan modifications, particularly for loans in private label securities that funded the credit for risky mortgages, which are most at need of modification, appear not to be occurring, even when economically rational. Barriers to this appear to include conflicting interests, poor incentives, and risks of litigation to modify loans deriving from mortgage servicing agreements. Voluntary efforts are not working. The rules of the game need to change. For example, economic incentives need to be put into place, perhaps through the TARP, so that banks will recognize losses now that will enable loan modifications to occur. There also need to be incentives for mortgage

servicers to do it "right," including covering costs of modifications with a bounty for performing successful modifications.

Given the freefall in housing markets and its implications for credit conditions and the overall economy, there is a need for policy to address the role of the financial sector and the mortgage servicing industry role in limiting the tsunami of impending foreclosures.

It is both necessary and possible to take action now. While housing values may not be far from fundamental values today, following the deflation of the credit bubble, as housing values fall, resolving the problem becomes increasingly difficult and costly. Thus, solutions that are now possible may not be available going forward. Without expeditiously and directly addressing the housing market mortgage crisis, the nation is at risk.

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