Peter Wallison, Arthur F. Burns Fellow in Financial Policy Studies,
American Enterprise Institute, March 19, 2013

Chairman Johnson, Ranking Member Crapo, and members of the Committee.

Thank you for the invitation to testify before the Committee today, and to discuss the future of the US housing finance system.

Many have pointed out that the Dodd-Frank Act ignored the fundamental causes of the financial crisis it was supposed to address. They note that the act imposed new, costly and growth inhibiting regulations on the entire financial system, but it failed to reform the U.S. government's housing policies. These fostered the creation of 28 million subprime and otherwise weak loans by 2008 and the development of a massive housing bubble between 1997and 2007. When the bubble began to deflate, weak and high risk loans began to default in unprecedented numbers, driving down housing values and weakening financial institutions in the U.S. and around the world.

In this testimony, I will outline the major provisions of a proposal for housing finance reform that I and two AEI colleagues, Alex Pollock and Edward Pinto, developed in response to a white paper issued by the Obama administration in February 2011. Although no specific action was ever proposed by the administration, the administration white paper advanced three options for housing finance reform. One of those options was what I would call a completely free market system. The proposal I will describe today was embodied in a much longer paper, entitled "Taking the Government Out of Housing Finance: Principles for Reforming the Housing Finance Market," that we issued in March 2011. That paper was intended to fill out the free market option that the administration had proposed and respond to questions raised in its white paper. I respectfully request that the complete proposal I will summarize today be included with the records of this hearing.

Our proposal is based on four principles that we believe should be the foundation of U.S. housing policy in the future. If these principles had been in place for the last 20 years, we would not have had a financial crisis in 2008. But that is water over the dam. We must now concentrate on reforming the U.S. housing finance system so that we do not face another housing-induced crisis in the future.

The four principles are the following:

I. The housing finance market—like other US industries and housing finance systems in most other developed countries—can and should function without any direct government financial support.

Under this principle, we note that the huge losses associated with the S&Ls and Fannie and Freddie—as well as the repetitive volatility of the housing business—did not come about in spite of government support for housing finance but *because* of government backing. Government involvement not only creates moral hazard but sets in motion political pressures for further and more destructive actions to bring benefits such as "affordable housing" to constituent groups.

Although many new ideas for government involvement in housing finance are being circulated in Washington, they are not fundamentally different from the policies that have

caused the losses already suffered by the taxpayers, as well as the losses still to be recognized through Fannie and Freddie.

The fundamental flaw in all these ideas is that the government can establish a risk-based price for its guarantees or other support. Many examples show that this is beyond the capacity of government, and is in any case politically infeasible. The problem is not solved by limiting the government's risks to mortgage-backed securities (MBS); the fact of the government's guarantee eliminates an essential element of market discipline in this case—investors' risk-aversion—so that the outcome will be the same: underwriting standards will deteriorate, regulation of issuers will fail, and taxpayers will take losses once again.

II. To the extent that regulation is necessary, it should be focused on assuring mortgage quality.

This principle is based on the idea that high quality mortgages are good investments and have a history of minimal losses. Instead of relying on a government guarantee to assure investors as to the quality of mortgages or MBS, we should simply make sure that the mortgages made in the U.S. are predominantly prime mortgages. We know what is necessary to produce a prime mortgage; these are outlined in our proposal. Before the affordable housing requirements were imposed on Fannie and Freddie in 1992, these were the standards that kept losses in the mortgage markets at minimal levels.

Experience has shown that some regulation of credit quality is necessary to prevent the deterioration in underwriting standards. The natural human tendency to believe that good times will continue—and "this time is different"—will always spawn bubbles in housing as in other assets. Bubbles in turn spawn subprime and other risky lending, as most participants in the housing market come to believe that housing prices will continue to rise, making good loans out of weak ones. Bubbles and the losses suffered when they deflate can be minimized by interrupting this process—by inhibiting through appropriate regulation the creation of weak and risky mortgages.

III. All programs for assisting low income families to become homeowners should be on-budget and should limit risks to both homeowners and taxpayers.

Our proposal recognizes that there is an important place for social policies that assist low income families to become homeowners. But these policies must balance the interest in low-income lending against the risks to borrowers themselves and the interests of the taxpayers. In the past, affordable housing and similar policies have sought to produce certain outcomes—for example, an increase in home ownership—without concern for how this goal would be achieved. The quality of the mortgages made under social policies can be lower than prime quality—the taxpayers may take risks for the purpose of attaining some social goods—but there must be limits placed on riskier lending in order to keep taxpayer losses within boundaries set by Congress and included in the budget.

IV. Fannie Mae and Freddie Mac should be eliminated as GSEs over time.

Finally, Fannie and Freddie should be eliminated as GSEs and privatized—but gradually, so that the private sector can take on more and more of the secondary market as the GSEs

depart. The gradual withdrawal of the GSEs from the housing finance market should be accomplished by reducing the GSEs' conforming loan limits by 20 percent each year, according to a published schedule embodied in statute so that the private sector knows what to expect. These reductions would apply to the conforming loans limits for both regular and the high cost areas. Banks, S&Ls, insurance companies, pension funds and other portfolio lenders will be supplemented by private securitization, but Congress should make sure that it doesn't foreclose opportunities for other systems, such as covered bonds.

These principles are the underpinning of a plan that assumes that housing, like virtually every other sector of the US economy, can and should be privately financed, and that the private market will produce a low-cost and stable system for financing homes.

In the white paper it released in February 2011, the Obama administration recognized the advantages for the economy and the taxpayers inherent in a free market housing finance system:

> The strength of this option is that it would minimize distortions in capital allocation across sectors, reduce moral hazard in mortgage lending and drastically reduce direct taxpayer exposure to private lenders' losses. With less incentive to invest in housing, more capital will flow into other areas of the economy, potentially leading to more long-run economic growth and reducing the inflationary pressure on housing assets. Risk throughout the system may also be reduced, as private actors will not be as inclined to take on excessive risk without the assurance of a government guarantee behind them.[1]

I can't improve upon this statement, especially when we consider the consistent failure of all government-based efforts to assist home ownership. In the post-war period, despite all the changes in the US economy, there have been only two instances in which an entire industry has collapsed, with terrible consequences for the economy and the American people as homeowners and taxpayers. These disasters—the collapse of the S&Ls in the late 1980s and the insolvency of Fannie and Freddie about 20 years later—were the result of government policies established for the purpose of helping Americans buy homes.

We could do it again. There are now many groups suggesting imaginative ways to get the government back into the housing business while avoiding, they claim, the mistakes of the past. These are illusions; the government's involvement in the housing finance business will always result in losses because it distorts incentives and creates moral hazard.

The disaster of Fannie and Freddie is a case in point. The two GSEs, for good reason, were widely believed to enjoy the backing of the federal government. This was denied repeatedly by the government, but in the end—when they became insolvent—the markets were correct that the government would rescue them. Proponents of government involvement have now turned this into a general principle that the government will always step in to rescue the housing market—thus creating a reason for the government to be there from the beginning.

Because Fannie and Freddie enjoyed the implicit backing of the government, they had access to funds at rates that were only slightly more than Treasury's. This enabled them to dominate the housing finance market and provide substantial profits to their shareholders and large

[1] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 27.

compensation packages for their officials. Moreover, and most important, because of their government backing no one cared about the risks they were taking. This was moral hazard, and it is moral hazard that is the unavoidable accompaniment to every government program that attempts to assist the housing system.

The fact that the GSEs could use their government support to produce slightly lower rates for middle class homebuyers made them a target for the supporters of other groups, both inside and outside Congress. In 1992, under pressure from community activists, Congress passed legislation that was intended to extend the GSEs' largesse to low income borrowers, and in the 2000s—under pressure from lawmakers who represented well-to-do districts—these benefits were also extended to high income groups. This is the way the government works in a democracy. It cannot be otherwise. Whatever benefits the government provides to some groups will eventually be extended to others. This is one of the reasons that the government should be kept out of the housing finance business. Even if a program is started on a reasonable basis, it is inevitably expanded and its costs and subsidies increased until it causes huge losses for the taxpayers and sometimes outcomes that are even worse.

The affordable housing goals are a particularly good example. Enacted in 1992, they originally required that at least 30% of the mortgages Fannie and Freddie bought had to be made to borrowers at or below the median income where they lived. But this modest requirement, that was probably easy to meet, was extended and tightened by HUD over succeeding years, so that by 2000 the Clinton administration adopted a 50% goal and the Bush administration pushed this requirement to 55%.

In order to meet these quotas, the GSEs had to abandon their traditional focus on prime mortgages and substantially loosen their underwriting standards. The rest is history, as they say. By 1995 they were buying mortgages with 3% downpayments, and by 2000 they were accepting mortgages with no downpayment at all. So by 2008, these two firms, with gold-plated franchises and the ability to dominate the largest market in the US, became insolvent, requiring the taxpayers, thus far, to keep them operating with more than $180 billion in financial support.

This or something like it will happen every time we put the government into the housing finance business. As too many people have already said, too many times, it is a sign of insanity to do the same thing over and over while expecting a different result.

How a private housing finance system would work

How, then, would a private system work? Our proposal is based on the simple idea that the housing finance market will operate steadily and stably if a high preponderance of the mortgages it processes through securitization are prime loans.

To achieve this will require a degree of regulation. That may come as a surprise to some who regard me and my AEI colleagues as "free market ideologues," but in fact all believers in the superiority of free markets realize that regulation is necessary and appropriate in cases of market failure.

We believe that the growth of housing bubbles, a natural phenomenon in free markets, is an example of market failure. Human beings simply cannot avoid the idea that this time it's

different—that the unprecedented growth they see around them is not a bubble but the reflection of a real change in how the world works. So they continue to buy until the bubble collapses.

That is not terribly harmful in commodity markets; the players there can generally take their losses. But in the housing market, as we have seen since the collapse of the giant bubble that developed between 1997 and 2007, the development and ultimate collapse of a bubble can be very destructive.

The reason such a large bubble developed is that housing bubbles tend to suppress delinquencies and defaults. As long as housing prices are rising, people who are in danger of default can refinance or sell the home for more than the amount of the mortgage. As weaker and weaker mortgages do not seem to be producing more delinquencies and defaults, lenders go further and further out on the risk curve and investors in MBS do not get the signals that should tell them their risks are increasing. The way to stop this from happening is to assure to the extent possible that only prime loans are securitized.

Our proposal, accordingly, would require that only prime mortgages be permitted into the securitization system. Subprime mortgages could be made, of course, but these would have to be held on private balance sheets and not securitized. Subprime lending can be a good business for people who understand the risks.

This is the only regulation we propose, but we believe it will be the foundation of a stable mortgage system if Congress can restrain itself from loosening underwriting standards again. Before the advent of the affordable housing goals, when Fannie and Freddie would only buy prime mortgages, the housing finance system was stable over all. Local bubbles developed, but could not grow to national proportions because the market for subprime loans was small without the GSEs' support. We believe a market like that can be recreated through regulation that assures only prime mortgages are securitized.

Let's be clear where the problem lies. Community activists, realtors and homebuilders want loose underwriting standards. Loose standards mean more people can buy homes, but none of these groups suffer the losses when the market collapses as it did in 2008. Who is visiting congressional offices asking for tighter mortgage underwriting standards? The answer is no one. Those who suffer are the taxpayers and the families that bought homes they couldn't afford.

The recent announcement of the Qualified Mortgage rule reflects an acceptance of the idea that the government—which will accede to the wishes of the Housing Industrial Complex—will loosen underwriting standards. Under the rule, once a lender determines that a borrower can afford the mortgage, there is no need to impose any requirement for a downpayment or a good credit history. All that is required is to obtain the approval of the GSEs or FHA and the mortgage can be considered a prime loan. That puts the whole question of mortgage quality back in the hands of the government, which has shown that it will worry more about increasing the availability of mortgage credit than creating a stable housing finance market.

Reasonable underwriting standards will not limit the availability of mortgage credit for those who can afford to carry the cost of a home. When Fannie and Freddie were establishing the standards for prime loans, and accepting only prime loans, the home ownership rate in the US

was 64%. In 1991, the great majority of conventional loans (defined as being Fannie eligible, other than by loan size) had the following characteristics:[2]

- 98 percent were loans on properties occupied as a primary or secondary residence.
- 94 percent were loans with a loan-to-value ratio (LTV) of 90 percent or less.
- 98 percent were to borrowers with one or no mortgage late payments at origination and 85 percent had two or fewer nonmortgage late payments at origination.
- 90 percent were loans with housing and total debt-to-income ratios of less than 33 percent and 38 percent, respectively.
- All loans had to be underwritten based upon verified income, assets, and credit.[3]

This was not, however, what the mortgage market looked like in 2008 after the effect of the affordable housing goals. Then, half of all mortgages—28 million loans—were subprime or otherwise weak because of because of low downpayments or other deficiencies. By 2008, the homeownership rate was almost 70%, but we paid a terrible price—a financial crisis—for adding that additional 5% to the home ownership totals.

Where would financing come from?

The next issue is who will buy mortgages and MBS that are not government guaranteed. One of the most common objections to a fully private housing finance system is that the customary buyers of GSE MBS will not accept the risk of MBS that are not government-backed. That may be true, but the customary buyers of government-backed MBS are not the only possible buyers. As discussed more fully at the end of this testimony, where I deal with all the traditional objections to a private financing system, the natural buyers of private MBS will be insurance companies, private pension funds and mutual funds, all of which are looking for long term investments to match their long term liabilities.

According to the Fed's Flow of Funds data, these investors—which collectively have about $21.5 trillion to invest—do not buy any significant amount of GSE or Ginnie MBS today. The reason is that these investors get paid for taking credit risk, and in the case of Ginnie and GSE MBS the risks have already been taken—by the taxpayers. As a result, the yields on these securities are simply not large enough to pay for their long-term liabilities. Instead, today, they are buying low quality corporate debt, which is risky but pays well.

If there were a steady flow of MBS based on prime mortgages, these financial institutions would be avid buyers as long as they can be assured of the quality of the underlying loans.

That assurance, under our proposal, would be provided by mortgage insurance (MI), which places the insurer's capital ahead of the investor's. We believe that the MI industry can be resuscitated into a viable system for providing assurance to institutional and other buyers of

[2] Data from Fannie Mae's random-sample review covering single-family acquisitions for the period October 1988–January 1992, dated March 10, 1992.
[3] Fannie stopped acquiring low-doc or no-doc loans in 1990. Freddie followed suit in 1991. See "Haste Makes . . . Quick Home Loans Have Quickly Become Another Banking Mess," *Wall Street Journal*, July 5, 1991

MBS. Recently, several new MI companies have been formed and capitalized, and legacy carriers have raised substantial additional capital, showing that investors believe that mortgage insurance has a future in the housing finance business once the GSEs are wound down and FHA limited to low income first-time home buyers.

Mortgage insurers do credit underwriting and place their capital at risk when they write their policies. This will provide assurance to institutional investors and others that the risks of buying private MBS have been assessed and covered by independent capital. We suggest that mortgage insurance provide coverage of mortgage defaults down to 60 LTV. Below that level, experience suggests that the losses are so few that credit enhancement is not necessary.

In discussions with mortgage insurers, we were advised that the combined cost of MI for the coverage of prime mortgages included in any privately securitized pool would permit private MBS to fund a freely prepayable 30 year fixed rate prime loan with an all-in annual cost about 20 basis points higher than Fannie's cost for the same loan. This of course assumes a normal market, not one in which the Fed is buying GSE MBS. If the administration continues to increase the GSEs' guarantee fees in order to provide more protection for the taxpayers, and a normal market returns, that difference could narrow significantly.

Accordingly, a private system of housing finance would operate at close to the cost of the current government-dominated system, without involving the risk that the taxpayers will eventually have to come to the rescue.

Small lenders and community banks.

The government's involvement in the housing finance market through Fannie and Freddie distorted the market's structure. Because the GSEs were able to bid more for mortgages than any competitors, they drove competitors from the secondary mortgage market and created a duopsony (a market with only two buyers). They were then able to discriminate among their suppliers, providing better returns to those, such as Countrywide,[4] who provided the mortgages that they wanted, and penalizing those—primarily the small banks and S&Ls—that were unable to compete in the volume they could supply. Congress has now banned this behavior, but through the Dodd-Frank Act and the Consumer Financial Protection Bureau has not created more obstacles for community banks to overcome.

The private market that will develop if our proposal is enacted will be entirely different from what existed before. Most mortgages will be prime loans—the kinds of loans that the small and community banks usually originate. These loans will be highly sought after because they will not only be good investments, but also the only kind of mortgage that could be securitized. Since most mortgages will have the same prime characteristics, the key function in this new market will be aggregating the mortgages into pools for securitization.

[4] "Mortgage Bankers Association chief economist Jay Brinkmann said the pricing strategies that Fannie and Freddie pursued contributed to the concentration of mortgage lending within the largest banks. The GSEs offered reduced 'guarantee fees' for their largest customers, which placed smaller lenders at a competitive 'disadvantage,' he told the NABE annual conference." See "NY Fed Thinks Megabanks May Be the New GSEs," *National Mortgage News*, March 16, 2011.

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This is a role that can be performed by the small and community banks, perhaps through the creation of a jointly owned and operated securitization facility, enabling the members to capture the profits that they previously had to give up to Fannie and Freddie or to their larger competitors. All that is necessary is regulatory approval to set up one or more joint ventures that will aggregate the mortgages produced by the members and prepare them for sale through securitization, or to institutional buyers who want to hold whole mortgages.

The more competitors in this field, the more innovation there will be and the lower they will push mortgage rates. This will be possible because the approach we have described relies on prime loans, a core competency of community banks and risk-based pricing.

FHA and low income borrowers.

There are good policy reasons for government to assist low-income families to become homeowners, but the value of this policy has to be weighed against the failure rate imposed on those ostensibly being helped as well as the cost to the taxpayers. Referring to the affordable-housing requirements imposed on Fannie and Freddie, even former House Financial Services Committee chair Barney Frank (D-MA) has noted that "it was a great mistake to push lower-income people into housing they couldn't afford and couldn't really handle once they had it."[5] Moreover, any program of this kind must be on budget and contain mortgage quality standards that do not create market conditions similar to those that brought on the financial crisis.

One of the ways to do this is to rein in FHA by limiting the scope of its lending, making sure its losses are sustainable over the long term, and putting it on budget through a mechanism more effective in identifying risks and losses than the Federal Credit Reform Act.

Government assistance to low-income families must not be undertaken without quality standards that limit the risks to homeowners, the government, and taxpayers. By prescribing an outcome it wanted through the affordable housing goals, without controlling the means, the government encouraged deteriorating underwriting standards. This inevitably led to greater lending with minimal down payments along with lending to borrowers with impaired credit and higher debt ratios.

Thus, if Congress wants to encourage homeownership for low-income families, then the mortgages intended to implement this social policy must be subject to a defined set of quality standards—not standards as high as those for prime mortgages, but standards that will ensure that working class families and neighborhoods are not subjected to excessive failure rates, as they did with Fannie and Freddie and the FHA, causing substantial burdens for taxpayers. The nation's experience with the FHA demonstrates not only that standards are essential, but also that Congress has to avoid the political and other pressures that tend to erode the standards over time.

Elimination of Fannie and Freddie over time.

A private housing finance market will never fully develop as long as long as Fannie and Freddie remain in existence, and yet it is obvious that they are essential to the current housing finance

[5] Larry Kudlow, "Barney Frank Comes Home to the Facts," GOPUSA, August 23, 2010, www.gopusa.com/commentary/2010/08/kudlow-barney-frank-comes-home-to-the-facts.php#ixzz0zdCrWpCY (accessed September 20, 2010).

system. What is necessary, then, is a workable transition plan—one that allows the GSEs to continue to function but opens the housing finance system to private securitizers.

A key transition feature that now appears to be generally accepted calls for a gradual reduction in the conforming loan limit that sets the maximum size of the mortgages that Fannie and Freddie can purchase. This idea is also in the BPC proposal. As this limit is reduced, Fannie and Freddie will be taken out of the market for loans above the limit, enabling private securitizers gradually to expand their activity.

The elements of the transition away from GSE status should include:

Reducing conforming loan limits. We recommend lowering the conforming loan limit by 20 percent of the previous year's cap each year, starting with the current general limit for one-unit properties of $417,000 and the high-cost area limit of $625,500. These limits, for loans, mean house prices of over $500,000 and over $800,000, respectively, are financed by the government. In contrast, according to the National Association of Realtors, the median US house price is $178,900. The general limit for a one-unit property would decrease to $334,000 in year one, $267,000 in year two, $214,000 in year three, $171,000 in year four, and $137,000 in year five. The high-cost area limit for a one-unit property would decrease to $500,000 in year one, $400,000 in year two, $320,000 in year three, $256,000 in year four, and $205,000 in year five. Final termination or "sunset" of GSE status would take place at the end of year five.

Winding down investment portfolios. A useful approach to winding down the GSEs portfolios, without disrupting the market, would prohibit Fannie and Freddie from adding existing or newly acquired single-family or multifamily loans or MBS to their portfolios, with exceptions only for newly acquired loans held for a short period before securitization and the purchase of delinquent or modified loans out of an existing MBS. With no additions allowed, natural runoff should substantially reduce their portfolios over time. Under the current trajectory the portfolios will be down to about $500 billion by the end of 2018. To the extent a GSE has portfolio assets remaining at the fifth-year sunset, these should be put in a liquidating trust and defeased or sold to other investors. During the wind-down period, Fannie and Freddie should be allowed to buy only prime loans.

Repeal affordable-housing goals and taxes. Consistent with Principles I and III above, repeal the GSE (including the FHLB) affordable-housing goals and affordable-housing support fees.[6]

Privatization. At the sunset date, the conservatorship will be converted to a receivership, the equity below the Treasury's holdings will be wiped out, and the GSEs will be divided into good bank/bad bank structures. If there are buyers for the GSEs as going concerns (no longer in GSE form), or capital is available for their restructuring as fully private nongovernment entities, the good banks will be sold and the bad banks will be liquidated by creating a liquidating trust that contains all remaining mortgage assets, guaranty liabilities, and debt. The obligations of the trust will be defeased with the deposit of Treasury securities.

Objections to a private housing financing system.

[6] Supra. Housing and Economic Recovery Act of 2008 (HERA). HERA imposed a 4.2-basis-point fee on Fannie and Freddie's mortgage purchases (currently suspended by FHFA).

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Proposals for largely eliminating government support for the housing market are usually met with a number of objections. None of them, in my view, should carry any weight when this Committee considers housing finance reform.

1. The government will step in anyway, so it should charge in advance to protect the taxpayers. Most recently, the Bipartisan Policy Center joined many others in arguing, in support of its housing finance proposal, that if there is ever a future disruption in the housing market the government is going to step in at some cost to the taxpayers. In that case, BPC and others have argued, this "reality" should be recognized; the government should create some kind of insurance system to cover the costs of its future actions and thus protect the taxpayers against loss.

But the history of housing finance makes clear that the government's role in the housing market—even if only as a brooding presence ready to act if the market collapses—will so distort the market that the government is eventually *required* to step in. This is a repeating pattern. For one example, the government had to rescue the S&Ls in the late 1980s and early 1990s because the government's own support for and regulation of the S&L industry had made it impossible for the industry to survive the changes in market structure that are inevitable in an evolving financial system. Similarly, the reason we are here today, and considering what to do about the GSEs, is the result of government housing policies that forced Fannie Mae and Freddie Mac to degrade their underwriting standards in order to comply government housing policies.

It does not matter how light the government's touch. In the proposal of the Bipartisan Policy Center that you will hear today, the government will have only a standby role in the housing market, stepping in only when the market is in trouble. Otherwise, the market will consist of private companies that will securitize mortgages and mortgage insurers that will insure them.

But it's easy to see that even the limited government role suggested by the BPC will have effects that will make a taxpayer rescue more likely. If the government is ultimately insuring the mortgage-backed securities (MBS) issued by private companies, the buyers of those MBS will not care about the quality of the underlying mortgages or the health of either the issuers or the mortgage insurers. That will remove from the market one major incentive for market discipline, and is one of the reasons the buyers of the GSEs' debt securities didn't care about either the quality of the mortgages they were securitizing or the GSEs' financial condition.

Then there are the firms that will be issuing the MBS in the BPC plan. These firms will have shareholders and creditors. Will the creditors believe that the firms will be allowed to fail? That's doubtful. The whole premise of the BPC system is that the government will step in if the market falters. It proposes a fund that will be available to back up the government's obligations. This sounds like a kind of FDIC, and we know how successful that's been. Like the FDIC, these elements will diminish, if not eliminate, the market discipline that might be exercised by the creditors of the MBS issuers in the BPC plan.

In addition, because the government is taking a risk in backing the issuers of the MBS, it will be regulating them. In the BPC plan, this will be done by the something called the Public Guarantor. Prudential regulation by this government agency will be another reason that investors in those firms or in the MBS they issue will not exercise market discipline—the government, they will believe, is doing that job. However, the collapse of the S&Ls, the failure of thousands of banks in the late 1980s and early 1990s, and the most recent financial crisis, not to speak of the collapse

of the GSEs themselves, should be ample evidence that government prudential regulation provides no assurance whatever that the regulated entities will not fail. It is important to keep in mind that only two months before the GSEs were taken over their regulator reported that they were adequately capitalized.

The mortgage insurers will also have both equity investors and creditors. Again, the interest these groups may have in the health of the MIs will be tempered by the government's presence. If the mortgage insurers should fail, the insurers' investors will believe, the government will rescue them. Again, that is the very premise on which the BPC's proposal is based. So if the BPC and others who make this argument are correct that the government will step in to protect the market, it is unlikely that investors in the MIs will pay much attention to their health, believing that the government will bail them out if they should get into trouble. That, in turn, will mean that the MIs will be likely to fail because they have insured the low quality mortgages that the issuers were able to sell to investors because of the government back-up.

The idea that the government can protect the taxpayers by charging a premium for its guarantees also does not stand up to analysis. The government doesn't have the incentives to charge a premium that fully compensates it for the risks it is taking, and Congress is often willing to respond to complaints from the industry that the premiums are too high and are operating as a tax on consumers. Thus, Congress just had to bail out the National Flood Insurance Program to the tune of $9.7 billion. The NFIP had been charging premiums for flood insurance for many years, but when the fund was really needed it wasn't large enough. If the government wants to do it as a matter of policy, OK, but Congress should realize that it will always end up as a cost to the taxpayers.

The history of government insurance programs is consistently dismal. The FDIC became temporarily insolvent in the 2008 financial crisis because Congress limited the amount it could charge for deposit insurance; the FHA is already insolvent and will have to be bailed out, the Pension Benefit Guarantee Corporation is also on its way to insolvency if not already insolvent. The pathology is always the same. The government accumulates a fund, but the fund was too small for the occasional catastrophic event. The reason the fund is too small is that the private sector interests that are supposed to be protected want to lower their costs, and persuade Congress that the fund is large enough. So premiums are lowered, or not increased as costs rise, or stopped altogether as occurred at the FDIC. When the catastrophe occurs, as it always does when the government is involved, the taxpayers have to pick up the tab.

And then there is moral hazard. The fact that the government would insure building in flood zones made it possible for people to do so. In the case of housing finance programs like that proposed by the BPC, the fact that the government—i.e., the taxpayers—is there as final guarantor will mean that the whole system will operate without taking full account of, and paying for, the risks it is creating. As a result, there will be greater demand for the product—more and more and bigger and bigger homes—and the financing will get riskier and riskier. In these cases, in theory, the government should add to the price of the insurance but is reluctant to do so. When the catastrophe comes, there will not be enough money in the fund to solve the problem and the weary taxpayers will have to pay up.

Finally, the idea that the government will step in to protect the housing market is a self-fulfilling prophesy. As noted above, the existence of the government backing—because of moral hazard—

makes default more likely. Once a fund of some kind is established, any restrictions on its use will fade away. A wholesale collapse of the industry will not be necessary; the failure of a single insurer or issuer will be enough to bring on a rescue. After all, what is the fund for but to protect the investors in the MBS? This in itself will prove to the market that the whole system is guaranteed by the government, removing any vestige of market discipline that might have previously existed.

2. Only the government can assure the existence of a 30 year fixed-rate mortgage. The first thing to say about this is that the government should not be encouraging 30 year fixed rate mortgages. They are harmful to most families that accept them. The second thing is that, if home buyers actually want 30 year fixed rate mortgages, the private sector already makes them available without any government support.

There are several commonly cited advantages of a 30 year fixed rate mortgage. It protects the borrower against rate hikes for 30 years, reduces the monthly payment, and increases the tax-deductibility of the monthly payment in the early years when most of the monthly payment consists of interest. Finally, in almost all cases the mortgage can be refinanced without penalty into another 30 years fixed mortgage at a lower interest rate if market conditions permit.

These sound like significant advantages, but that is illusory. First, most families do not stay in a home for 30 years; the average is about seven, so when families take out 30 year fixed rate mortgages they are paying for the lender's 30 year risk when they will not ever need it. A shorter maturity mortgage is less expensive and better meets the needs of most families, which would be well served by a 5, 10, or 15 year fixed period, with a 20, 25 or 30 year amortization. Last week, Wells Fargo was offering a 30 year fixed rate conforming (i.e., non-jumbo) mortgage at a rate of 3.75%, and a 15 year conforming mortgage at almost a full point less, at 2.875%. The point is that a private market would mix and match the elements of a mortgage to better meet the needs of particular families for the lowest possible cost.

In addition, when a family that has taken out a 30 year fixed rate mortgage finally sells its home to buy another they will not have accumulated very much equity. Most of their payment has been interest, and this interest rate has been higher than if they had chosen a 15-year loan. It is true that they have received a tax deduction for this interest payment, but that is only if they itemize their deductions, and only 33% of families itemize.

The idea that government backing is required for a 30-year, fixed-rate loan has some surface plausibility. Many people who don't follow the financial markets might assume that lending money for that long a period at a fixed rate would be too risky for the private sector. Just about everyone in Congress seems to have been visited by a representative of the Housing Industrial Complex claiming that the 30 year mortgage would not exist without government backing.

However, anyone can prove this assumption is wrong, simply by going to Google and typing in "30-year jumbo fixed rate mortgage." The word "jumbo" is mortgage market jargon for loans that are too large to be bought by Fannie or Freddie, or insured by the Federal Housing Administration. That means a jumbo mortgage is not backed in any way by the government. Still, a Google search will return many offers of jumbo fixed rate loans. I found one offered by Wells Fargo last week at 3.875%, about 12.5 basis points higher than the 30 year fixed rate conforming (i.e., non-jumbo) loan that Wells was offering at the same time.

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In other words, government backing is not necessary to make this loan available to homeowners, although the government subsidy that comes with the conforming loan—where the taxpayers are taking the risk—could well be responsible for the 12.5 basis point difference in rate.

We should have no objection, of course, if homeowners want this type of loan. The question is whether the taxpayers should take on the risk of backing the entire housing finance structure in order to provide a 12.5 basis point subsidy to homebuyers, most of who don't need the 30 year fixed rate mortgage they are assuming.

Finally, we have just come through a period where everyone has seemed to recognize the dangers of leverage. Many in Congress preach fervently against excessive leverage. Perhaps they don't realize that a 30 year fixed-rate mortgage is one of the principal ways that leverage is built into the housing system. As noted above, it takes many years before a homeowner builds up equity in the home through a 30 year fixed rate mortgage. This means that for all this time the homeowner is using credit—leverage—to carry the home. If there is a market downturn during this period, the homeowner is likely to be underwater and unable to sell the home, a victim of leverage encouraged by the government's promotion of the 30 year fixed rate mortgage.

3. The investors in MBS are rate buyers. They do not want to take credit risk. Without government backing, and the assurance of a risk-free investment, it is argued, we would not be able to find investors for MBS in the US and around the world.

This argument confuses cause and effect. It is true that most of the buyers of GSE and Ginnie MBS do not want to take credit risk. According to the Fed's Flow of Funds data, the principal buyers of Ginnie Mae and GSE MBS are US banks, foreign central banks, and Federal, State and local pension funds. These entities are buyers *because* they are looking for returns without risk. If there were no Ginnie or GSE MBS, they would be buyers of Treasuries. This means that Treasury is paying more for its outstanding debt because it competes with GSE securities. In a recent memorandum, Steve Oliner, an AEI economist, and I estimated this cost to the Treasury at about $22 to $28 billion per annum, more than what the government is now receiving in GSE dividends.

In the private sector, however, investors are compensated for taking risks. They are not generally buyers of Ginnies and GSE MBS because the taxpayers are taking the risks associated with those securities and the yields are too low to meet their long-term obligations.

Insurance companies, private pension funds and mutual funds should be the natural buyers of mortgages and MBS. These are long term assets that would match their long-term liabilities. But as shown again by the Fed's Flow of Funds data, they are not buyers of government-backed MBS, probably because the yields are too low when the taxpayers are assuming the risks (and not being compensated for it). In the absence of private MBS, these investors are generally buying low quality corporate securities.

If there were a steady flow of private mortgage credit in the form of whole mortgages and MBS, insurance companies, private pension funds and mutual funds—which together have about $13 trillion to invest—would be steady buyers. This would set up a financial win-win, in which there would be adequate credit for mortgages and a sound investment for long-term investors.

4. Without government backing there would be no TBA market and interest rates for all mortgages would rise. This is also incorrect. The TBA (To Be Announced) market is a hedging mechanism, which allows lenders to hedge the possibility of interest rate changes between the time they lock in a rate for a borrower and the time the loan actually closes. This is done by selling the pool of mortgages forward, just as a farmer might sell his wheat or corn crop forward. Then, if the price changes, he is protected. The buyer is speculating that wheat will be worth more when delivered than it is on the date of the forward sale. So in the same way, the mortgage lender sells its pool of mortgages forward to a buyer who is speculating that the mortgages will be worth more in the future when they are ultimately delivered. There are two keys to the effective operation of a TBA market—market liquidity and a general agreement on the principal terms of the mortgages in a MBS pool.

In the current TBA market, in which the GSEs are the principal players, the liquidity is created by a convention among market participants about what they will accept as sufficient information about a particular mortgage pool. The agreement covers six factors—issuer, maturity, coupon, price, par amount and settlement date. Participants in the market agree to buy a pool of mortgages that all fall within certain previously-agreed parameters. It's the agreement on these parameters not creates the liquidity, not the government guarantee of the credit risk. The credit risk is occasionally a factor, but the purpose of the TBA market is to hedge interest rate risk, not credit risk.

Once the private market become active enough so that there is a liquid market for the purchase and sale of mortgage pools the TBA market will function.

5. Without government involvement, a steady flow of credit to housing cannot be guaranteed. Why should housing, as opposed to all other industries, be guaranteed a steady flow of credit? Every other industry has to live with the prospect that interest rates will rise and credit will be tight. This encourages prudence and care in making commitments, reduces overbuilding and the use of leverage that has contributed to housing bubbles in the past. A steady flow of credit to housing has, ironically, been the cause of much of the volatility in the housing market in the past.

That concludes my prepared testimony.