

Taking the Government Out of Housing Finance: *Principles for Reforming the Housing Finance Market*

An American Enterprise Institute
Policy White Paper

Peter J. Wallison Alex J. Pollock Edward J. Pinto

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Executive Summary

Many commentators have pointed out that the Dodd-Frank Act ignored the fundamental causes of the financial crisis it was supposed to address. While imposing new, costly and growth inhibiting regulations on the entire financial system, the act failed to reform the US government's housing policies—policies that fostered the creation of 27 million subprime and Alt-A loans and the inflation of a massive housing bubble between 1997 and 2007. When the bubble began to deflate, these weak and high-risk loans started to default in unprecedented numbers, driving down housing values and weakening financial institutions in the United States and around the world.

Implicit in most of the proposals for reforming the housing finance system is the idea that institutional investors will not buy mortgage backed securities (MBS) backed by US mortgages unless they are issued by a government sponsored enterprise (GSE), a US government agency, or are otherwise guaranteed by the US government. We believe, however, that there is a robust alternative to government support of the housing finance system—a system which in the past has led to large scale taxpayer bailouts and losses. Our alternative approach is to ensure that only prime quality mortgages, which comprise the vast majority of US mortgages, are allowed into the securitization system. The very low delinquency and default rates on prime mortgages will be attractive investments for institutional investors and enable the housing finance system to function effectively with no government support. This will eliminate the potential for additional taxpayer losses in the future, and allow the eventual elimination of Fannie Mae and Freddie Mac.

In order to implement our approach, in this white paper we outline four basic principles on which US housing policy should be based in the future. If these principles had been in place for the last twenty years, we would not have had a financial crisis in 2008. But that is water over the dam. The current interest in replacing Fannie Mae and Freddie Mac provides another opportunity to adopt reforms that will prevent a recurrence of another financial crisis in the future.

The four central principles of our plan are the following:

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

Under this principle, we note that the huge losses associated with the Savings and Loan debacle of the late 1980s 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 also 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 failures of the past, including the substantial losses in the S&Ls and the losses still to come from Fannie and Freddie. The fundamental flaw in all these ideas is that the government can successfully establish an accurate risk-based price or other compensatory fee 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 government’s guarantee eliminates an essential element of market discipline—the risk aversion of investors—so the outcome will be the same: the 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 ensuring mortgage credit quality.

This principle is based on the fact that high quality mortgages are good investments and have a history of minimal losses. Instead of relying on a government guarantee to assure investors of the quality of mortgages or MBS, we should simply make sure that the mortgages made in the United States are predominantly prime mortgages. We know what is necessary to produce a prime mortgage; these characteristics are outlined in this white paper. Before affordable housing requirements were imposed on Fannie and Freddie in 1992, these were the standards that kept credit losses in the mortgage markets from affecting the entire economy.

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 the creation of weak and risky mortgages through appropriate regulation.

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

The third principle 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 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—which turned out to escalate the risks for both the borrowers and the taxpayers. 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 quality and budgetary limits placed on riskier lending in order to keep taxpayer losses within reasonable bounds.

IV. Fannie Mae and Freddie Mac should be eliminated as government-sponsored enterprises (GSEs) over time.

Finally, Fannie and Freddie should be eliminated as GSEs and privatized—but gradually, so the private sector can take on 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 conforming loan limit by 20 percent each year, according to a published schedule so the private sector knows what to expect. These reductions would apply to the conforming loans limits for both regular and high-cost areas. Banks, S&Ls, insurance companies, pension funds, and other portfolio lenders would be supplemented by private securitization, but Congress should make sure that it does not foreclose opportunities for other systems, such as covered bonds.

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

Given the spectacular failures of US housing finance and the enormous cost to taxpayers of two massive bailouts in twenty years, the housing industry should be required to show why it needs government support again.¹ No other developed country provides anything that approaches the support for housing provided by the US government, and—as shown below—many of these other systems produce higher homeownership rates,² lower mortgage interest rates (see table 1) and fewer losses when defaults occur (see table 2).

In the last twenty years, US taxpayers have had to pay for bailouts of two major elements of the housing finance system: the S&Ls in the late 1980s and early 1990s and the GSEs Fannie Mae and Freddie Mac beginning in 2008. As two commentators described it, the S&L crisis of the 1980s and early 1990s “produced the greatest collapse of US financial institutions since the Great Depression. Over the 1986–1995 period, 1,043 thrifts with total assets of over \$500 billion failed. The large number of failures overwhelmed the resources of the Federal Savings and Loan Insurance Corporation (FSLIC), so US taxpayers were required to back up the commitment extended to insured depositors of the failed institutions. As of December 31, 1999, the thrift crisis had cost taxpayers approximately \$124 billion and the thrift industry another \$29 billion, for an estimated total loss of approximately \$153 billion.”³

Today, taxpayers face even larger losses arising from the insolvency of Fannie Mae and Freddie Mac, both of which are now operating in conservatorships controlled by the government. Thus far, the Treasury has contributed approximately \$150 billion to keep the two GSEs solvent; but the Federal Housing Finance Agency (FHFA), the GSEs’ regulator, has estimated that their losses will fall between \$221 billion and \$363 billion. If housing prices continue to fall, many observers believe the total losses of the GSEs will eventually exceed \$400 billion.

The taxpayer losses in both the S&L and GSE debacles are related; as we will show, they are the inevitable result of extending government guarantees or subsidies to the housing finance industry. Before Congress considers any action on the future of housing finance it should ask those who are pressing for government backing to explain why the taxpayers should be put at risk again.

Recent research by Dwight Jaffee, set out in table 1, documents that, notwithstanding the absence of government guarantees in most cases, many housing finance markets have achieved better outcomes than the US market along a number of critical dimensions.⁴ For example, as

¹ In principle 3, we discuss how the government should proceed with respect to providing financial support for social policy purposes.

² *Testimony of Alex J. Pollock, Subcommittee on Security and International Trade and Finance, U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Cong. (September 29, 2010).

³ Timothy Curry and Lynn Shibut, “The Cost of the Savings and Loan Crisis: Truth and Consequences,” *FDIC Banking Review*, December 2000, http://fcx.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf (accessed January 14, 2011)

⁴ Dwight M. Jaffee, “Reforming the U.S. Mortgage Market through Private Market Incentives” (presentation, Federal Reserve Bank of St. Louis, November 17, 2010) <http://research.stlouisfed.org/conferences/gse/Jaffee.pdf> (accessed January 14, 2011).

table 1 shows, the United States has one of the highest mortgage debt levels (column 1) and among the highest mortgage interest rates (column 5) and spreads (column 6), yet is only average in owner occupancy rates (column 2). This is not an enviable record, and certainly not what American taxpayers deserve for all the losses they have covered to support the housing industry.

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

(Statistical measures computed with annual data by country for 1998 -2008)

	(1)	(2)	(3)	(4)	(5)	(6)
	Mortgage to GDP Ratio	Rate of Owner Occupancy	Coefficient of Covariation Housing Starts	Standard Deviation of House Price Inflation	Mortgage Interest Rate Average Level	Mortgage Interest Rate Average Spread**
	2008	2008				
Western Europe						
Austria	25.3%	57.0%	8.3%	2.6%	5.12%	0.66%
Belgium	39.8%	78.0%	16.3%	4.0%	5.87%	1.37%
Denmark	95.3%	54.0%	40.8%	6.1%	5.96%	1.41%
Finland	47.5%	59.0%	11.0%	3.4%	4.5%	0.05%
France	35.9%	57.4%	16.4%	5.5%	4.93%	0.53%
Germany	46.1%	43.2%	30.1%	0.8%	5.27%	0.97%
Iceland	129.0%	82.5%	56.3%	9.8%	5.01%	0.64%
Ireland	80.0%	74.5%	35.8%	11.5%	4.69%	0.22%
Italy	19.8%	80.0%	47.0%	3.1%	5.25%	0.64%
Luxembourg	43.5%	75.0%	19.2%	4.3%	4.33%	-0.16%
Netherlands	99.1%	57.0%	10.2%	5.5%	5.17%	0.77%
Norway	55.7%	77.0%	21.1%	5.0%	6.54%	1.61%
Portugal	63.3%	76.0%	31.5%	5.4%	5.15%	0.61%
Spain	62.0%	84.5%	32.5%	2.5%	4.38%	-0.09%
Sweden	60.6%	52.0%	53.9%	5.1%	4.05%	-0.49%
UK	80.5%	59.0%	10.5%	5.0%	5.32%	0.42%
Euro Average	61.5%	66.6%	27.6%	5.0%	5.10%	0.57%
US Average	83.6%	67.8%	24.9%	5.5%	6.57%	1.82%
US Rank	4th of 17	9th of 17	9th of 17	4th of 17	1st of 17	1st of 17

Notes:

* Unless noted otherwise, the data are all from European Mortgage Federation (2008), an annual fact book that contains comprehensive mortgage and housing market data for 1998 to 2008 for the sixteen Western European countries and the United States.

** The mortgage interest rate spread equals the mortgage interest rate (column 5) relative to the government bond rate of each country derived from the International Financial Statistics of the International Monetary Fund.

Moreover, Jaffee's research also shows that when recent bubbles deflated in these other countries, the number of delinquencies and foreclosures was much lower than in the United States. All the countries in table 2 below had housing bubbles during the 2000s, some of them even larger than the one in the United States, but the outcomes in these countries were far better.

Table 2: Troubled Mortgages: Western Europe and the United States

	≥ 3 Month Arrears %	Impaired or Doubtful %	Foreclosures	Year
Belgium	0.46%			2009
Denmark	0.53%			2009
France		0.93%		2008
Ireland	3.32%			2009
Italy		3.00%		2008
Portugal	1.17%			2009
Spain		3.04%	0.24%	2009
Sweden		1.00%		2009
UK	2.44%		0.19%	2009
U.S. All Loans				
U.S. All Loans	9.47%		4.58%	2009
U.S. Prime	6.73%		3.31%	2009
U.S. Subprime	25.26%		15.58%	2009

Source: European Mortgage Federation (2010) and Mortgage Bankers Association for U.S. Data.

With this background, it is time to examine why the US housing finance system fails so consistently, even though since the 1930s it has been supported or backed by a growing phalanx of government agencies and enterprises (Federal Housing Administration, Fannie, Freddie, FSLIC, Federal Home Loan Banks, and Ginnie Mae).

The reason, we believe, is that the US system fails *because* of its connection to the government. Government guarantees create moral hazard on two levels. First, by assuring the housing industry of a steady supply of underpriced funds, government support encourages overbuilding and speculation. In other industries, variations in the availability of funding suppress risk taking. In addition, by relieving investors of risk through a guarantee, government support makes it possible for mortgage originators to offer liberal lending terms such as zero or low down payment loans, loans without documentation, and loans to credit-impaired borrowers.⁵

The result is not the stability the industry is seeking but a repetitive volatility—the growth and deflation of housing bubbles leading to credit crises such as the one that occurred in 2008. It is because of excessive government intervention in the housing market that we now have both historically high borrower leverage and a clearly inadequate amount of capital backing a debt market consisting of \$10.6 trillion in first and second mortgages.⁶

⁵ Additional commonly-used provisions include: negatively amortizing loans (option ARMs), ARMs as an affordability aid, liberal terms for cashing out equity, minimal right to recourse or enforcement of same, second mortgages (sometimes hidden), and loans to investors/speculators masquerading as prospective homeowners.

⁶ Fannie and Freddie, now, with no capital of their own, guarantee about 45 percent of all outstanding mortgages. The FHA, with about \$5 billion in regulatory capital (likely much less or none on a GAAP basis), guarantees another 10 percent, and commercial and savings banks own another 25 percent, which on a mark to market basis are substantially underwater. Most of the remainder is in the form of private MBS, also substantially underwater.

Accordingly, for the reasons outlined below, our first principle is that the housing finance system should be free of any government assistance in the future, other than for social policy reasons through FHA and other explicitly government programs.

1. *The government cannot successfully price for risk.* Many of the plans currently making the rounds in Washington depend on government backing at some level—usually as a guarantor of MBS issued by a financial intermediary. Rumors about the nature of the forthcoming administration plan are to the same effect. These plans are based on a fundamental error: that the government can act like an insurance company and set a correct price for the risk it is taking. There are three reasons why this cannot be done:

(i) Unlike an insurance company, the government has no profit incentive to price for risk, and because risk-pricing can seem arbitrary and unrelated to current conditions, the government has many incentives to avoid the controversy that risk pricing entails;

(ii) If the government actually attempted to set a price for mortgage risk, it would be discriminating among its citizens, since some present greater risks than others; this would inevitably bring the risk pricing project to a halt; and

(iii) Successful insurance systems require the build-up of reserves during good times to pay claims during the inevitable bad times, but the government lacks the discipline and incentives to follow through. During the good times, the government comes under political pressure not to increase a reserve fund by continuing to collect fees or premiums. The argument is made that the times are different, the fund is large enough, or even that the industry is strapped for investment capital. These pressures cause the government to let it ride, to refrain from collecting the necessary fees or premiums. This has occurred with the National Flood Insurance Program,⁷ the Pension Benefit Guaranty Corporation,⁸ the FHA,⁹ and the Federal Deposit Insurance Corporation (FDIC).

Recent FDIC experience is symptomatic of government's tendency to avoid collecting the necessary premiums. When the deposit insurance system was reformed in 1991 in response to the failure of the FSLIC, Congress placed a limit on the size of the deposit insurance fund that the FDIC could accumulate to meet the demands of a future crisis. Since 1996, the FDIC has been prohibited by law from charging premiums to well-capitalized and stable institutions. As a result, between 1996 and 2006, institutions representing 98 percent of deposits paid no deposit

⁷ "FEMA Administrator Craig Fugate says the debt results partly from Congress restraining insurance rates to encourage the purchase of coverage, which is required for property owners with a federally backed mortgage.... 'It is not run as a business,' Fugate said. Congress' Government Accountability Office said in April that the program is 'by design, not actuarially sound' because it has no cash reserves to pay for catastrophes such as Katrina and sets rates that 'do not reflect actual flood risk.' Raising insurance rates or limiting coverage is hard. 'The board of directors of this program is Congress,' Fugate said. 'They are very responsive to individuals who are being adversely affected.'" (Thomas Fink, "Huge Losses Put Federal Flood Insurance Plan in the Red," *USA Today*, August 26, 2010.

⁸ As of the end of FY2010, the Pension Benefit Guaranty Corporation (PBGC) reported a deficit of \$23 billion. "In part, it is a result of the fact that the premiums PBGC charges are insufficient to pay for all the benefits that PBGC insures, and other factors." Pension Benefit Guaranty Corporation, "2010 PBGC Annual Report," www.pbgc.gov/about/ar2010.html (accessed January 14, 2011)

⁹ Barclays Capital estimates that the FHA has drastically underpriced the risk of its guarantees and could face losses of up to \$128 billion. Barclays, "US Housing Finance: No Silver Bullet," December 13, 2010

insurance premiums. In 2009, FDIC chair Sheila Bair observed: “An important lesson going forward is we need to be building up these funds in good times so you can draw down upon them in bad times.”¹⁰ Instead, once the bad times hit, the FDIC was forced to raise its premiums at the worst possible moment, thereby reinforcing the impact of the down cycle. Principle II will discuss in greater detail the need for countercyclical reserving policies.

2. A government guarantee of MBS alone will have the same effect in creating taxpayer losses as any other guarantee. Several of the ideas recently advanced for government backing of the housing market have suggested that the government’s guarantee would extend only to MBS and not to the issuers of these securities. These plans would obligate the government to pick up losses only after the capital of an MBS issuer has been exhausted and would require the issuer to pay a fee to the government to cover the government’s risks. This idea is presented as though it will prevent losses similar to those that have resulted from the operations of Fannie and Freddie—that the government’s risks will be reduced and the likelihood of taxpayer losses will be minimized.

But it’s an illusion. As noted above, the fee to cover the government’s risks cannot be effectively set by the government. Even if government had the incentives and capabilities to assess a proper fee, the assessment would be seen and attacked as an unfair tax on those who are using the government’s services. For example, when the Office of Management and Budget suggested near the end of the Clinton administration that Fannie and Freddie pay a fee for the government’s risk on its implicit backing of their obligations, the idea was immediately derided as a tax on homeownership, the administration was inundated with protests from the housing industry, and the proposal was promptly abandoned. Apart from whether a fee can be credibly established, it is fanciful to believe that any government will have the political fortitude to impose a fee that burdens homeowners because of the risks they pose to taxpayers.

Nor is the problem solved—as many of the supporters of these guarantee plans suggest—if the government is liable for losses on guaranteed MBS only after the issuer of the MBS has absorbed the first losses and exhausted its capital. It is true that in this case issuers will have an incentive to be cautious about risk taking, but the government guarantee eliminates an important element of market discipline—the risk aversion of investors. These securities will undoubtedly be sold worldwide as US government credit. The existence of a government guarantee will mean that no MBS buyer needs to be concerned about the quality of the underlying loans or the financial stability of the issuer. This is exactly analogous to the effect of deposit insurance on risk taking by banks. As is well known, deposit insurance permits bank depositors to ignore the risks a bank is taking—the principal reason that so many banks fail. As in the case of deposit insurance, government backing of MBS will eliminate investor concerns about both the financial stability of the issuer and the quality of the mortgages underlying the MBS. This will introduce destructive moral hazard into the housing finance system, allowing the expansion of risks through the securitization of very low-quality mortgages.

¹⁰ Center on Federal Financial Institutions, “Federal Deposit Insurance Corporation,” August 10, 2005, www.coffi.org/pubs/Summaries/FDIC%20Summary.pdf (accessed January 14, 2011). See also Congressional Budget Office, “Modifying Federal Deposit Insurance,” May 9, 2005, “Currently, 93 percent of FDIC-insured institutions, which hold 98 percent of insured deposits, pay nothing for deposit insurance.”

The protection of the government and the taxpayers in these cases will then supposedly come through—regulation—another prescription of the advocates of government backing for MBS. They argue that regulation of the issuer will ensure that it has sufficient capital to cover the risks it is taking and thus to protect the government and the taxpayers from loss. But experience with bank regulation has shown that it does not prevent excessive risk-taking and does not ensure sufficient capital to cover risks. Moreover, regulators are frequently unable to determine the financial condition of a regulated entity until it is too late. In these cases, the taxpayers will once again end up holding the bag.

3. Government backing distorts prices, resource allocation, and competition. The fact that the government cannot price for risk should be an important clue about the distorting effect its guarantee will have on competition. For the reasons outlined above, the government's charge for supporting one sector of the housing market will be lower than what the actual risk would demand, so its backing will operate as a subsidy for the sector of the housing market it is actually covering. For an equivalent risk, the government-guaranteed mortgage will always be cheaper than the privately backed mortgage. This simply means that the taxpayers are providing a benefit to the borrower and the lender. The real costs to society appear later.

As a result, private competitors will be driven out of any sector of the market where the government guarantee is offered. Moreover, political pressures will make it attractive to extend the benefits of the lower-cost government-backed mortgage to more constituents, expanding the size of the sector that will be covered by the guarantee, and thus gradually extending the government's obligations to cover a larger sector of the market.

We have seen this before. With Fannie and Freddie able to borrow at much lower rates than others because of their implicit government backing, they drove all potential private competition out of the market for fixed-rate prime loans at or below the conforming loan limit, and most mortgage originators preferred to direct their production to Fannie and Freddie, which could offer them the best pricing. Political pressure—to allow more members of the public to get the benefits of the taxpayer subsidy—also extended the subsidized market into an area that had previously been reserved for private activity. Thus, when Congress enacted the Housing and Economic Recovery Act of 2008,¹¹ it raised the conforming loan limit for Fannie and Freddie so buyers of million-dollar homes would have access to the benefits of the taxpayer subsidy provided free to Fannie and Freddie. Accordingly, if a government guarantee is again introduced into the housing sector, it will gradually grow to squeeze out private nongovernmental financing of mortgages. In other words, it will be unlikely that Congress, once it allows any portion of the housing market to be covered by a government guarantee, will be able to place any effective limits on the extent of the taxpayers' risks.

4. It is a myth that only a government guarantee can make a thirty-year fixed-rate mortgage available. Those who argue for a government role in housing finance frequently contend that the thirty-year fixed-rate mortgage will not be available without government backing. On its face, this is not true, since anyone can go to the Internet and find lenders offering jumbo fixed-rate thirty-year loans—which, by definition, have no government backing. It is true that a thirty-year fixed-rate mortgage is somewhat more expensive than a government-backed thirty-year fixed-rate mortgage, since the lender is taking a longer-term risk on interest rates, but

¹¹ *Housing and Economic Recovery Act of 2008*, Pub. L. No. 110-289 (July 30, 2008).

the lower cost of the government mortgage simply means that the taxpayers—as well as all other mortgage borrowers who are not taking thirty-year fixed-rate mortgages—are providing a subsidy to the person who wants a government-backed mortgage with these terms.

History has shown—and simple economics would anticipate—that a government subsidy for a thirty-year fixed-rate mortgage is not good policy. The subsidy causes most borrowers to choose the thirty-year fixed-rate loan, since in general it offers the lowest monthly payment for a loan of a given size. However, the loan amortizes slowly; this keeps the homeowner’s equity low and corresponding debt level high over the life of the loan. None of the proponents of government backing ever explains why the taxpayers and other mortgage borrowers should be subsidizing this particular type of mortgage. For homeowners who want a thirty-year fixed-rate loan, as noted above, it is available for a slightly higher cost without a taxpayer subsidy.

We believe that in a market without government guarantees, borrowers would have a variety of solidly underwritten loan choices. What the interest rates would actually be depends, of course, on monetary and fiscal policy in the United States. As an example of what the loan menu might look like, we take a historically typical spread of about 2 percent over the ten-year Treasury rate for a thirty-year fixed-rate jumbo loan and assume a 4 percent yield on the ten-year Treasury note. (The average spread on a thirty-year fixed-rate jumbo loan was a little under 2 percent, and the average ten-year Treasury yield was about 4 percent, for 2002–2008.) This gives a base price of 6 percent for a jumbo, thirty-year fixed-rate, freely prepayable mortgage. A loan with the same structure, but guaranteed by Fannie or Freddie, would be slightly less costly because of the government subsidy. A 2005 study estimates the differential at about thirty basis points;¹² a Federal Reserve study in 2005, on the other hand, estimates the differential at seven basis points.¹³ Whichever is correct, the benefit associated with the government subsidy is far outweighed by the detriments a government role carries with it.

In the list below, we use the 6 percent jumbo fixed-rate mortgage as a benchmark to estimate the range of probable rates for a series of mortgages with different characteristics that would be available in a nongovernment market. In this market, we would expect some borrowers to select a thirty-year fixed-rate freely prepayable loan at an interest rate of 6 percent with others selecting a different option based on their needs and cost. These options offer a lower rate for a shorter maturity and/or a lower rate if borrowers choose a loan with a prepayment fee:

6.00%	thirty-year fixed-rate term with no prepayment fee
5.625%	thirty-year fixed-rate term with a 3-2-1 prepayment fee ¹⁴
5.375%	thirty-year amortization with fifteen-year fixed-rate term and a 3-2-1 prepayment fee

¹² Anthony B. Sanders, “Measuring the Benefits of Fannie Mae and Freddie Mac to Consumers: Between De Minimis and Small?” July 2005, <http://fic.wharton.upenn.edu/fic/papers/05/0536.pdf> (accessed January 14, 2011).

¹³ Wayne Passmore, Shane M. Sherlund and Gillian Burgess, “The Effect of the Housing Government Sponsored Enterprises on Mortgage Rates,” **Federal Reserve Board Finance and Economics Discussion Series**, January 2005, <http://www.federalreserve.gov/pubs/feds/2005/200506/200506abs.html>

¹⁴ A prepayment fee of 3 percent in year one, 2 percent in year two, 1 percent in year three and zero percent thereafter.

5.375%	fifteen-year fixed-rate term with no prepayment fee
5.125%	fifteen-year fixed-rate term with a 3-2-1 prepayment fee
5.00%	seven-year ARM with thirty-year amortization underwritten at fully indexed seven-year rate with no prepayment fee
4.75%	seven-year ARM with thirty-year amortization underwritten at fully indexed seven-year rate with a 3-2-1 prepayment fee

5. *Should the government guarantee a steady flow of credit for housing?* One of the key arguments for a government support in housing finance is that only with such support can a steady flow of credit to the housing market be assured. Originally, this argument was based on past experience which is no longer relevant. Government regulation of interest rates, specifically the old Regulation Q deposit rate ceilings, caused frequent periods when banks and savings and loans could not offer competitive rates for savings. The result was that mortgage lending, housing construction and house sales were severely impaired. However, after Regulation Q was eliminated, this ceased to be a problem.

Now the argument has changed; in the event of a financial crisis, it is said, the government should make sure housing gets credit and funding in preference to manufacturing, commerce, consumer credit, or anything else. This proposed preference is hard to defend on economic grounds. Indeed, most of the time, the involvement of the government in housing finance creates a danger in the opposite direction: that of excess supply of credit to housing relative to all other sectors. Government involvement helps encourage homebuilders to overbuild, lenders to overlend, and borrowers to overborrow. In other words, it is a source of moral hazard.

If participants in the housing market are insulated from the changes in the market, they will take more risks and be less prudent in their investment decisions. This is what helped create housing bubbles in the past. The possibility that financing for housing could be subject to disruption or financing restrictions is, of course, one of the risks the housing industry fears, but that fear will reduce the overbuilding and excessive leverage that have caused volatility and repeated housing bubbles in the past. Other industries, of course, manage perfectly well to survive fluctuations in the availability or cost of funding.

A related and frequently cited reason for a government role in housing finance is what is known as TBA—or “To Be Announced”—MBS. TBA permits homebuyers to “lock in” an interest rate with a bank or other financing source when they agree to purchase a home. In this case, the bank uses a hedging strategy to make sure that when the funds are called upon it will be able to supply them at the interest rate originally agreed to with the homebuyer, even if market rates have changed. The bank’s hedging strategy has a cost, and it will be included in the rate that the bank quotes for the loan. The additional hedging cost is not a major factor in the interest

rate. There is no reason for the government to be involved in this, or for the taxpayers to support a whole system of government housing finance in order to make sure it is available.¹⁵

6. Is a government guarantee is necessary to sell MBS to institutional investors and others? Finally there is the argument—sometimes explicit and otherwise implicit—that institutional investors will only buy US mortgages, or MBS backed by US mortgages, if they are supported by a government guarantee. This is probably the key reason for the support that government backing of housing finance continues to enjoy in Washington. It would certainly be a weighty argument if the quality of the mortgages were generally low; in that case, delinquency rates and defaults would be high, and the risks of investment in mortgages or MBS could well be unacceptable for institutional investors such as insurance companies, pension funds, mutual funds and others. But as discussed below, there is no reason why mortgages have to be of low quality, especially the mortgages allowed into the securitization system.

Until the introduction of the affordable housing requirements for Fannie and Freddie, the GSEs maintained high underwriting standards and never suffered substantial losses on the mortgages they held or guaranteed. Indeed, their charter required them to purchase only prime loans. Section 1719 of Fannie’s charter stated: “[T]he operations of the corporation...shall be confined...to mortgages which are deemed by the corporation to be of such quality, type, and class as to meet, generally, the *purchase standards imposed by private institutional mortgage investors.*”¹⁶ [emphasis added]

Even in the current crisis, their delinquency rates among *prime* mortgages have been less than 3 percent, while their delinquency rates on the subprime and Alt-A loans they acquired because of the affordable housing goals have ranged from 13.3 to 17.3 percent.¹⁷ Accordingly, the key to a successful mortgage market is not a government guarantee—which will inevitably cause serious losses to the taxpayers—but ensuring that the mortgages that are made in the market are of prime quality.

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

Many people have noted that when Congress adopted the Dodd-Frank Act (DFA) it failed to address the real causes of the financial crisis—the government housing policies that enhanced the size and duration of the housing bubble and encouraged the creation of 27 million subprime and Alt-A loans. When the bubble finally began to deflate, these weak and high-risk loans began to default at unprecedented rates, weakening financial institutions in the United States and around the world that were holding either these mortgages or the MBS they backed. If Congress had properly diagnosed the causes of the financial crisis before it began drafting the enormously complicated and unnecessary DFA, it would instead have enacted legislation to correct the

¹⁵ See Kevin Villani, “The Future of US Housing Finance: Why a Competitive Market Oriented Housing Finance System Is Still Best,” November, 2010, <http://chicagoboyz.net/blogfiles/TheFutureVII.pdf> (accessed January 14, 2011).

¹⁶ http://www.law.cornell.edu/uscode/html/uscode12/usc_sec_12_00001719----000-.html

¹⁷ Pinto, “Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study,” November 4, 2010, chart 53, <http://www.aei.org/docLib/Government-Housing-Policies-Financial-Crisis-Pinto-102110.pdf>.

deficiencies in government policy and the mortgage market that were the source of the financial crisis of 2008.

The general conclusion of economic theory is that regulation is only appropriate when there is a market failure, and recent (and not so recent) experience demonstrates that normal market conditions—and such key elements as market discipline—are not capable of preventing the downward slide in mortgage underwriting standards as a bubble develops.

It is typical to see increasing leverage (and thereby expanding or maintaining demand) during the growth portion of the cycle. This is done through reduced down payments, increased reliance on so-called affordability products such as adjustable-rate loans and interest-only loans, increased leverage on income, and expanding eligibility to borrowers with impaired credit. At the same time, existing homeowners seek mortgages that will enable them to buy larger homes with nearly the same monthly payment. As prices outpace incomes, nontraditional lending expands to meet the new or greater affordability gap. Lenders accede to these requests because they believe that rising home prices limit their risk of loss. This may keep the “up” portion of the cycle growing, but it weakens the underlying strength of the market, adding particular vulnerability for the most recent borrowers. We have enough experience with housing bubbles now to realize that, although they will occur to some extent no matter what we do, we can reduce their likelihood by ensuring the maintenance of sound credit standards.

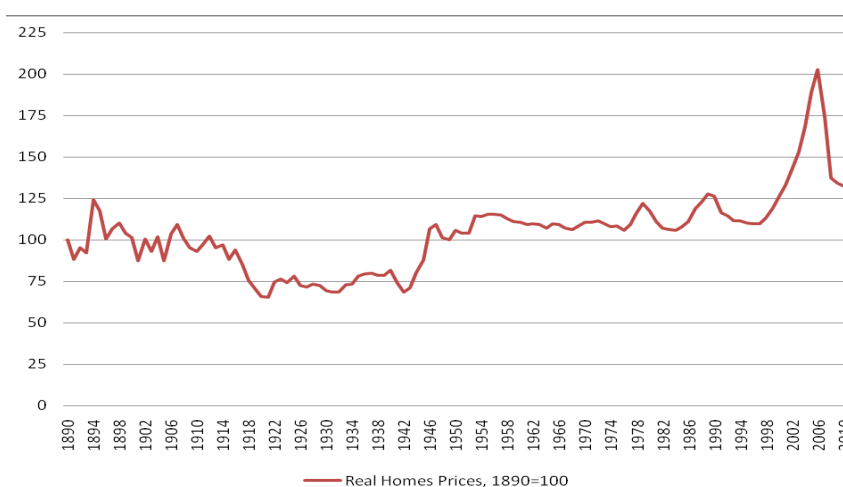
One of the characteristics of bubbles is that they are difficult to recognize while you are inside, but very easy to recognize in hindsight. Also, the fact that they occur in many assets other than mortgages suggests that they reflect the human tendency to explain away unusual circumstances on the ground as “this time it’s different.” However, real estate bubbles have been particularly harmful to the US economy when they collapse; the prescriptions in this paper—while they will not entirely prevent bubbles—will go a long way toward making them less likely.

Since the 1920s, there have been at least four real estate booms followed by two serious corrections and two busts.¹⁸ The boom periods were the 1920s (17 percent real home-price increase), the late 1970s (16 percent real home-price increase), the late 1980s (20 percent real home-price increase), and 1997–2006 (85 percent real home-price increase).

Figure 1 shows the trend of real home prices since 1890. The real-price trend clearly shows the recent bubbles in 1979, 1989, and 1997–2006.

¹⁸ The real-price boom that occurred over 1942–1955 (72 percent real-price growth) is excluded given the unusual circumstances relating to World War II and the postwar baby boom. By 1955, real prices had recovered to their late 1890s to early 1900s trend line.

Figure 1: Real Home Prices, 1890–2010



There are common elements in all these episodes: government support for increasing homeownership, widespread use of second mortgages to reduce down payments, excessive leverage, reliance on adjustable-rate and negatively amortizing loans, higher debt-to-income ratios, and extensive use of low- and no-doc loans. This suggests that with limited regulatory intervention, the effects of bubbles in the United States can be mitigated. That is, bubbles will occur, in housing as in other fields, but when they deflate they will not be as destructive as in the past. If we can address these common elements through regulation focused on credit quality, we can accomplish what the DFA will fail to do: prevent another financial crisis arising from a proliferation of weak mortgages.

Accordingly, beyond removing government subsidies and guarantees from housing finance, much can be accomplished simply by adopting six policies for the regulation of housing finance in the future:

1. Ensure that a high preponderance of loans are prime. We should adopt policies to ensure that a preponderance of all mortgages in the future will be of prime or high quality. This should not be difficult. According to a Federal Reserve study, over 70 percent of all individuals with credit records in the US (not just all homeowners with credit records) have FICO credit scores that are 660 or above—the foundation for a prime loan. Well over a majority (58 percent) have credit scores above 700.¹⁹ Nevertheless, to ensure the continuing quality of mortgage loans, it is appropriate to define the characteristics of loans with relatively low default rates. The characteristics of a prime loan do not generally change over time, an experience confirmed over long periods in the United States and other developed countries. Historically, prime loans had a default rate of less than one in one hundred loans.²⁰ Loans with private mortgage insurance have experienced a default rate of about five in one hundred loans.²¹ Loans with FHA insurance have

¹⁹ Federal Reserve Board, “Federal Reserve Report to Congress Credit Scoring and Its Effects on the Availability and Affordability of Credit,” <http://www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf>, August 2007

²⁰ Derived from Freddie Mac data.

²¹ Standard & Poor’s Ratings Direct Report, December 27, 2008.

experienced a default rate in excess of ten in one hundred loans.²² See Appendix 1 for details on defining a prime loan.

2. Correspondingly, nonprime loans should be a relatively small percentage of all loans. Given that the market share of nonprime loans tends to grow as a boom develops, these loans—characterized by low or no down payments, increased debt ratios, impaired credit, reduced loan amortization, loans to investors or speculators, and other underwriting standards not present in prime loans—must be limited to a relatively small percentage of all mortgage loans. It is the accumulation of these loans that first buoy, then capsize a regional or national housing market. Nonprime loans are unsuitable to serve as collateral for private MBS, covered bonds, and FHLB advances.²³ This provision would be enforced by the Securities and Exchange Commission in the case of securities and bonds and FHFA in the case of FHLB advances. See Appendix 2 for further details.

3. Allow securitization only for prime loans. The DFA proposes a cumbersome and possibly unworkable system of risk retentions in cases where loan securitizations do not involve a Qualified Residential Mortgage (QRM), which is to be defined by regulation. In light of the earlier discussion of bubbles—in which we described the relationship between declining underwriting standards and the growth of bubbles—it makes more sense simply to require that the securitization system be used only for prime loans. That would do away with retentions and the need for a QRM. Nonprime loans could then be held in the portfolios of banks, insurance companies, pension funds, and other financial institutions, but only if the market transparency described in number six below allows investors, rating agencies, and others to understand how many such nonprime loans are outstanding.

4. Require a one-page mortgage-information disclosure form. This form would present clear, straightforward key information that allows borrowers to answer the question, “Can I afford this loan now and in the future?” See Appendix 3 for an example of what this form should contain.

5. Counter government expansionary policy choices that promote overexpansion by increasing the availability of credit while reducing lending standards. For many years, government policies have focused on expanding homeownership by reducing the cost of credit while at the same time promoting looser credit standards. This resulted in increased demand, debt levels, leverage, and inflation in adjusted and real home prices. These policy choices reinforced the tendency of the market to rely increasingly on nonprime loans as a boom progresses and the bubble grows. Regulation is necessary, then, to counter the propensity of the government to enact only expansionary policies and limit the government and private sector’s origination of nonprime mortgages.

We need counterexpansionary and countercyclical policies such as the following, which automatically apply the brakes as risk levels rise.

²² FHA’s 2010 and 2003 Actuarial Studies.

²³ Ginnie Mae securities backed by government agency loans would be exempt.

- **Countercyclical leverage requirements for high LTV or CLTV loans.** Homeowner and investor leverage tend to grow as housing prices rise; lenders respond to homebuyer demands for loans that will allow them to buy a more expensive house while keeping low monthly payments. Not only are down payments reduced, but loan-to-value ratios are also increased by combining first and second mortgages to create high combined loan-to-value ratios (CLTVs). A well-designed countercyclical policy would require, for example, that LTVs and CLTVs be automatically reduced (that is, down payments would be increased) when housing prices have risen by a given percentage in a local area. This would slow housing-price growth by directly reducing the leverage that homeowners can use to increase the price they will pay for homes. As housing prices return to normal levels, LTVs and CLTVs would do the same. In addition, second mortgages or other junior lien mortgages should only be permitted where the first mortgage holder has given its consent.
- **Countercyclical loan-loss reserves.** Under current accounting standards, loan-loss reserves for banks and others are set based on recent delinquency and loss rates. However, bad loans are made in good times, when they seem good. The lean years inevitably follow the fat years, but under current reserve practices reserves are at their lowest levels at the beginning of a bust. Reserves should be built during good times, not bad.
- **Better appraisal practices.** Appraisers should report an estimated value using both the principle of substitution based upon comparable sales²⁴ and the principle of income capitalization based upon investment value as a rental.²⁵ Additionally, appraisals have long suffered from a lack of transparency in the selection of comparables.²⁶ This process would be remedied by identifying all appropriate comparables and using statistical techniques to help the appraiser select and reconcile all appropriate comparables. Transparency would allow the reader to validate and re-create the appraiser's comparable selection process. These provisions would be applicable to all federally related mortgages²⁷ and mortgages serving as collateral for private MBS and covered bonds.

6. Provide market transparency so investors, rating agencies, and guarantors are always able to determine the number of mortgages outstanding and their quality both at the point of origination and over time. Mortgage markets work best when aggregate risk levels are low and stable, but market participants must understand the true conditions in the market so they can properly assess the risk of investment. Nonprime loans increased rapidly over the period 1991–2007. This is best demonstrated by the rapid growth of home purchase loans with little or no downpayment. In 1990 one in two hundred home purchase loans had a downpayment of 3% or less, by 1999 it was one in ten, 2003 one in seven and 2007 one in two and a half. The extraordinary level of nonprime lending created a fragile market that adversely affected

²⁴ The cost of acquiring a comparable property fixes the upper limit of valuation. This is accomplished by identifying and evaluating suitable comparable properties that recently sold.

²⁵ The capitalization of expected income (rents) fixes an upper limit of valuation.

²⁶ Edward Pinto 1991 unpublished study.

²⁷ Generally, loans originated by institutions regulated by banking regulators or purchased or guaranteed by a federal agency or sponsored enterprise.

homeowners, mortgage insurers, and mortgage investors. It is not clear that anyone in the market or in government in 2007 and 2008 understood the dimensions of the nonprime mortgage problem. Fannie and Freddie did not disclose the number of subprime and other nonprime mortgages they were buying, holding, and securitizing, and thus even close students of the mortgage markets did not know what they did not know. Accordingly, the first line of defense is to make sure that the mortgage finance market has the information necessary to understand the amount of nonprime lending that is occurring.

The following keys would reduce the tendency of people, lenders, and investors to believe that just because housing prices are rising, it is sensible or prudent to originate or buy a mortgage loan that will only be repaid if housing prices *keep* rising:

- Better disclosure of the characteristics and delinquency rates of mortgages originated, sold, and held by investors is essential for an informed market.
- Due diligence from the lending and securitization industry to confirm that originated loans are as described as related to owner occupancy and the presence of second mortgages. The results of this due diligence would be disclosed.

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

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 and 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 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.”²⁸ 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. Finally, after all the years of trying and failing to increase homeownership without adding risk to the markets, perhaps it is time for Congress to rethink whether homeownership really should be given so many advantages over renting. With a more even-handed policy, rental properties would offer improved housing for people who are unable to—or should not be required to—take on the obligations of homeownership.

Much of the support for a government role in mortgage finance comes from groups that see housing finance as an opportunity to advance a social policy that expands homeownership. This is a worthwhile goal, but it must be carefully controlled if we are to avoid the problems that eventually forced Fannie and Freddie into insolvency. Fannie and Freddie successfully facilitated the development of a liquid secondary market in middle-class mortgages. In 1992, they were

²⁸ 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).

given an affordable-housing mission, which eventually required them to take on the credit risk of almost \$2 trillion in subprime and other weak mortgages.

What set US losses apart from those in other countries was the fact that—before the financial crisis began—about half of all mortgages in the United States, 27 million loans, were weak and liable to default when the housing bubble deflated. Of the 27 million high-risk mortgages, 19 million were on the books of Fannie and Freddie, FHA, insured banks and S&Ls under the Community Reinvestment Act, and other lenders under additional government programs. All of these programs were intended to increase homeownership by low-income families, but they were instituted and operated without any controls over the risks that were being taken under government mandates. Eventually, their high rates of default drove down housing prices nationally and crippled the financial system.

Government assistance to low-income families must not be undertaken through affordable-housing mandates without quality standards to limit the risks to the government and taxpayers. By prescribing an outcome without limiting the means, the government encouraged loans and underwriting standards that were “flexible and innovative.” This inevitably led to greater lending with minimal down payments along with lending to borrowers with impaired credit and higher debt ratios.

These policies assumed that borrowers who benefited from these flexibilities would be nearly as safe as borrowers with good or unimpaired credit. However, the risks that resulted from these underwriting concessions were well documented. A 1996 Fed study entitled “Credit Risk, Credit Scoring, and the Performance of Home Mortgages”²⁹ pulls together unequivocal evidence from multiple sources on the high risks posed by “innovative or flexible” loan features such as low down payments and impaired credit/low FICO scores. It clearly shows the link between the government’s insistence on loosened and flexible lending and the certainty of heightened mortgage default risk. See Appendix 4.

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 losses do not get out of hand or, as they did with Fannie and Freddie and the FHA, cause substantial burdens for the 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. See Appendix 5.

Any social policy intended to increase homeownership, including the FHA, should be operated to achieve Congress’s social policy goals while limiting homeowners’ and taxpayers’ risks. This can be achieved through the following steps.

1. On budget. Necessary subsidies must be on budget, so they are visible to members of Congress and the voters. In the past, through Fannie and Freddie and the Community Reinvestment Act, the subsidies have been hidden in the financial statements of GSEs and private-sector entities, which were required to make subsidized loans and pay for them with

²⁹ Federal Reserve, Division of Research and Statistics, “Credit Risk, Credit Scoring, and the Performance of Home Mortgages,” *Federal Reserve Bulletin*, July 1996, www.federalreserve.gov/pubs/bulletin/1996/796lead.pdf (accessed January 14, 2011).

more expensive loans to prime borrowers. This, of course, is unfair to prime borrowers, who are being forced to pay for a social policy the cost of which should be borne by all taxpayers. But perhaps even more important, hiding the cost of the subsidies in private and GSE balance sheets obscures the cost to society. There are very good policy reasons for supporting low-income housing subsidies, but those costs should be made clear.

2. A sustainable loss rate. Although the FHA contends that it covers its losses adequately with fees, there are many who disagree with this view. A recent Barclays study concluded: “[W]e project cumulative default rates in the 20% area on average, with loss given default rates of 60%. This represents average losses of about 12pts, of which 8.5pts could flow back to taxpayers. On an original balance of \$1.4trn, this translates to \$130bn.”³⁰

3. Assist low-income borrowers without competing with private-sector lending. Lending to low-income borrowers is done to increase the opportunity for families that cannot meet prime lending standards to gain the benefits of homeownership. Since it is done for social policy reasons, the taxpayers should take some risk in order to achieve the benefits of increasing homeownership among low-income families. However, the taxpayers’ risks must be subject to some limits. The following low-income mortgage lending standards would provide credit for families that cannot meet prime loan standards but would still enable low-income families to become homeowners without exposing them or the taxpayers to excessive foreclosure risk:

- **Limit to low-income borrowers.** The FHA’s benefits should be limited to low-income borrowers who are demonstrably unable to meet prime lending standards. This is important to ensure that the FHA is fulfilling its social policy purposes rather than becoming a backdoor way for people who could otherwise meet prime lending standards to obtain mortgages at government-backed rates. Accordingly, the mortgage limit should be capped at 100 percent of median house values measured on the local level, the income limit should be capped at 80 percent of the area median income, and loans should be limited to home purchases and rate and term refinances.
- **A sustainable lending underwriting standard.** As outlined in Appendix 5, the FHA seems to believe that a 10 percent average claim rate is acceptable. It is a shocking idea that, year in and year out, homeowners with an FHA loan should be forced to endure a failure rate of 10 percent on FHA loans. Congress should establish a sustainable loan underwriting standard that achieves an expected cumulative risk of default not to exceed 4 percent during good times and 9–10 percent during bad times.³¹ This would result in an average expected claim rate of about 5 percent, which is about half of FHA’s historical average of over 10 percent. The standards needed to achieve this claims level include the accumulation of adequate borrower equity by way of a reasonable downpayment from the borrower’s own funds, scheduled amortization during the first five years of the loan, evidence of a willingness to pay, and debt-to-income ratios that do not leave borrowers burdened with excessive debt right from the start. This supports a major goal of single-

³⁰ Barclays, “US Housing Finance: No Silver Bullet,” 6.

³¹ During the boom years of 1995–2003, the FHA’s cumulative claim rate averaged nearly 8 percent. During the bust periods (1980–1985 and 2005–2008), it averaged 18 percent. See the FHA’s 2010 Actuarial Study.

family affordable housing programs—wealth building through increased equity in a home.

4. Transition. Because the FHA currently has such a large portion of the home-lending market, transitioning to a sustainable lending standard will take a few years. Table 3 presents a possible path to achieve this result.

Table 3: FHA Transition to Sustainable Lending Standards

	LTV	Maximum seller concession	Maximum total debt ratio	Purpose	Mortgage limit (high/normal)	Income	Credit
2010	96.5% (current level)	6%	>45% for 37% of borrowers	Home purchase and refinance	\$729,750/ \$271,050	No limit	Current
2011	96%	3%	45%	Home purchase	\$500,000/ \$250,000	100% of area median	620–660 FICO ³²
2012	95.5%	3%	43%	Home purchase and rate and term refinance	\$400,000/ \$200,000	80% of area median ³³	620–660 FICO
2013	95%	3%	41%	Home purchase and rate and term refinance	\$250,000/ \$200,000	80% of area median	620–660 FICO
2014	95% at twenty-three-year term* 90% at thirty-year term*	3%	41%	Home purchase and rate and term refinance	100% of median home price by area	80% of area median	620–660 FICO

* By setting a twenty-three-year loan term on 95 percent LTV loans at an interest rate of 5 percent and a thirty-year loan term on 90 percent LTV loans at an interest rate of 5 percent, each borrower would have about 18 percent equity (based on original sales price) at the end of five years.

5. Down payments and savings. The FHA provides its benefits through the traditional means used in the United States—by subsidizing the cost of a mortgage loan. However, that is not the only way—and possibly not the most effective way—to achieve its purposes. Studies by the US Census Bureau have shown that the greatest obstacle to homeownership among low-income families is not the monthly cost of the mortgage but the savings necessary for a down

³² As noted previously, the FHA’s serious delinquency rate on loans with a FICO score of 580–619 is 19.6 percent.

³³ The goal is to reduce the FHA’s dollar limit back to a level commensurate with its low- and moderate-income housing mission. The FHA should serve homebuyers with an income less than or equal to 80 percent of the median. While regional adjustments would be appropriate, nationally, for a family of four, this equates to an income of \$54,000 and below. A household with an income of \$54,000 getting a 6 percent fixed-rate thirty-year mortgage could afford the median-priced house in the United States—about \$175,000.

payment.³⁴ Accordingly, one of the ways for Congress to assist homeownership among low-income families within the lending standards we suggest would be to establish a program for providing down payment assistance to these families. Such a program should be designed to promote saving by the potential homebuyer. For example, Congress could set up a tax-preferred savings plan to which the government contributes an amount each year that matches a family's savings. The funds in the account could be used only as a down payment for a home. If established to complement the contractual saving system described under principle 4, it might prove to be a better way to serve a portion of the low-income homebuyer population.

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

Fannie Mae and Freddie Mac violate every principle of sound and sustainable housing finance. The history of these two hybrid firms, and the immense costs they have imposed on taxpayers, provides the best argument for the principles we have outlined in this paper. Through Fannie and Freddie, government policies exponentially increased taxpayer risks, now realized as actual losses, by using the two firms to compete with the FHA in pursuing a political strategy of high-risk loans. Fannie was “privatized”—really, GSE-ized—in 1968 for the explicit purpose of keeping its costs out of the federal government's budget. Freddie copied the model. But the costs have returned to the budget with a vengeance. Fannie and Freddie distorted resource allocation, prices, and credit and were leading contributors to inflating the disastrous housing bubble. As a result, almost everyone now agrees, including almost everyone in Congress, that Fannie and Freddie's GSE status should be eliminated. This leaves two questions: What should replace the GSEs? How should the transition be structured? We conclude that the GSEs should be—and can be—replaced by a housing finance market that is for the most part free of government guarantees and the distortions they create.

No private-sector system of financing mortgages will be able to develop fully until competition from Fannie and Freddie is first reduced, and then disappears. However, a sensible transition away from the dominance of Fannie and Freddie must be designed, allowing private banking, securitization, and covered bond markets in mortgages to grow. Accordingly, while we target the elimination of Fannie and Freddie as GSEs, we propose a gradual wind-down, with mandatory congressional decisions after three and five years.

A key transition feature should be a gradual reduction in the conforming loan limit that sets the maximum size of the mortgages that Fannie and Freddie can purchase. As this limit is reduced, Fannie and Freddie will be taken out of the market for loans above the limit. This will enable the private market to expand its activity gradually.

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

- **Reduce conforming loan limits.** 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 \$729,750. These limits, for loans with 80 percent LTV, mean house prices of over \$500,000 and over \$900,000,

³⁴ Howard A. Savage, *Who Could Afford to Buy a House in 1995?* (Washington, DC: US Department of Commerce and US Census Bureau, August 1999).

respectively, are financed by the government. In contrast, according to the National Association of Realtors, the median US house price is \$171,300. The general limit for a one-unit property would decrease to \$334,000 in year one; \$267,000 in year two; and \$214,000 in year three. The high-cost area limit for a one-unit property would decrease to \$584,000 in year one; \$467,000 in year two; and \$374,000 in year three. At this point, the first formal review of the GSE transition would take place. If the transition is judged to be proceeding successfully, and unless the Congress votes to the contrary, the 20 percent annual reductions would continue through year five. Final termination or “sunset” of GSE status would take place at the end of year five.

- **Phase out portfolios.** Prohibit the holding of loans or mortgage securities in the GSEs’ portfolios, except for short periods as necessary to support MBS issuance during the transition period. The GSEs’ current mortgage portfolios and corresponding debt should be put in run-off mode, steadily decreasing as loans and MBS in their portfolios are repaid. To the extent a GSE has portfolio assets remaining at the fifth-year sunset, these should be put in a liquidating trust or sold to other investors.
- **Limit acquisitions to prime loans.** During the wind-down period, allow Fannie and Freddie to buy only prime loans.
- **Limit nonmortgage investments.** Limit the GSEs’ nonmortgage investment portfolio to short-term Treasury bills. This prevents them from arbitraging their GSE status.
- **Privatization structure.** At the sunset date, mirror the privatization structure used for the former GSE, Sallie Mae, creating a liquidating trust containing all remaining mortgage assets, guaranty liabilities, and debt. The GSE net worth shortfall will unjustly—but at this point unavoidably—be borne by taxpayers, including Treasury’s writing off its preferred stock. Any additional losses would be on budget pursuant to the Credit Reform Act.
- **Dispositions of other properties.** All of Fannie and Freddie’s intellectual property, systems, securitization platforms, goodwill, customer relationships, and organizational capital should be auctioned off in a privatization. The proceeds would reduce the Treasury’s and taxpayers’ losses.
- **Repeal affordable housing goals and taxes.** Consistent with principles 1 and 3 above, repeal the GSE (including the FHLB) affordable-housing goals and taxes and move all affordable-housing programs into the Department of Housing and Urban Development and onto the federal budget.

1. Coincident with the wind-down of Fannie and Freddie, Congress should establish a legal structure that allows for a number of private financing options. Although we believe a combination of a market based on portfolio lending and securitization of loans would be the most effective immediate replacement for a government-backed housing finance system, there are many other alternatives. Covered bonds would make a sensible additional fixed-rate funding alternative for mortgages. With covered bonds, banks issue debt for which they remain liable

(thus, having 100 percent “skin in the game”), secured by loans.

This could include incorporating some of the benefits of the Danish system, which divides the credit and interest-rate risks on mortgages, and the German system, which has strict mortgage credit standards. In the Danish system, the interest rate on mortgages is set by the market directly, and the credit risk is taken by specialized mortgage banks that also function much like mortgage guarantors. Throughout the more than two-hundred-year history of German covered bonds, there has never been a default of a German Pfandbrief or covered bond³⁵ or a default by a Danish mortgage bank. For such a system to work, there must be statutory (not just regulatory) protection of the right of the bondholders to the collateral in the event of the failure of the issuer, as well as a requirement that the mortgages covering the bonds be of prime quality. Thus, any framework that establishes requirements for mortgage quality should be compatible with a variety of mortgage financing structures, all of which should be able to operate simultaneously in the US market.

The political obstacle in the United States has been the objections of the Federal Deposit Insurance Corporation, which fears that in the event of a failure, it will lose assets that would otherwise be part of a bank and thus increase its losses to its deposit-insurance scheme, like what happens with FHLB advances. This concern can be addressed by limiting the extent of collateralization of the covered bonds (for example, the percentage of overcollateralization might be limited to the capital ratio of a bank, so that the excess collateral is in effect funded by capital, not deposits).

2. The four principles outlined in this white paper are equally applicable to multifamily housing finance. The federal government has long supported the multifamily housing finance market. This support includes government insurance (FHA), MBS guarantees (Fannie, Freddie, and Ginnie), on budget subsidies (HUD and Department of Agriculture), off-budget mandates (Fannie and Freddie), off-budget subsidies (FHLBs), and low-income tax credits (prior to Fannie and Freddie’s collapse, they were the largest purchasers). Historically, life insurance companies, pension funds and banks supported a robust conventional multi-family lending market.

In the late-1970s HUD pushed Fannie and Freddie to undertake multifamily lending as part of its early efforts to enforce a GSE affordable housing mission. These programs proved to be high risk, with Freddie completely exiting the multifamily business in the late-1980s after sustaining substantial losses.³⁶ The 1992 act, by imposing affordable housing requirements for multi-family as well as single-family mortgages, forced Freddie back into multifamily finance and both GSEs were required to greatly expand their programs. As was the case with single-family financing, the private sector had an ever more difficult time competing with GSEs’ charter advantages. Today Fannie and Freddie,³⁷ along with FHA, have now largely taken over the multifamily finance market.

³⁵ Association of German Pfandbrief Banks, “The Pfandbrief—A Safe Investment,” [www.hypverband.de/cms/bcenter.nsf/docsbykey/65192645/\\$file/Flyer+EN_Pfandbrief_a+safe+investment.pdf?openelement](http://www.hypverband.de/cms/bcenter.nsf/docsbykey/65192645/$file/Flyer+EN_Pfandbrief_a+safe+investment.pdf?openelement) (accessed January 14, 2011).

³⁶ Fannie also lost substantial sums on a \$5 billion portfolio of 6% multifamily loans it had acquired from HUD when long and short term interest rates topped 15% in the early-1980s.

³⁷ “In the current market, the GSEs hold 35 percent of total outstanding multifamily mortgage debt and are providing nearly 90 percent of all mortgage capital to the market.” Ellen, Tye, Willis, May 2010, “Improving U.S.Housing

Many of the proposals for reform of the housing finance system argue for continued federal government financial support for multifamily housing,³⁸ either through an explicit or implicit government guarantee of agency or private MBS or the need for a GSE or other similar entity with substantial ongoing portfolio capacity.

A detailed treatment of multifamily housing finance is beyond the scope of this white paper. However, the lessons from the single-family disaster have direct applicability to multifamily housing finance and the risks posed to taxpayers. While the multifamily lending business is less than \$1 trillion in size or under 10 percent of the single-family finance market, it is even more complex and risky than the single-family lending business. Although the GSEs' recent multifamily lending efforts have resulted in low losses, there is a long history of costly multifamily failures at the GSEs and at FHA. It is also clear from the various industry proposals for future GSE participation in multifamily lending that there will be pressure to move the GSEs and FHA into riskier types of loans. Combine this with continued federalization of multifamily mortgage credit and the risks to taxpayers are substantial.

The four principles outlined in this white paper are equally applicable to multifamily housing finance. The inability to price risk, or create reserves for potential losses, and the moral hazard created by government financial support for the industry will have the same adverse effect in multifamily housing as it has had in the single-family market. The presence of federal guarantees and mandates will distort the incentives and the behavior of borrowers, lenders, and investors alike, and prevent the multifamily market from developing normally with private sector support.

As is the case with single-family finance, a gradual removal of government support by the GSEs and FHA, and the resulting price advantage, will be necessary in order to give traditional financing sources time to re-enter the business. This will allow a private multifamily financing sector to develop based on solid underwriting and the use of financing mechanisms already available.

Finance through Reform of Fannie Mae and Freddie Mac: Assessing the Options”

http://furmancenter.org/files/publications/Furman_Center_GSE_Reform_White_Paper_May_2010.pdf

³⁸ Id. See also “MBA’s Recommendations for the Future Government Role in the Core Secondary Mortgage Market”, August 2009,

http://www.mbaa.org/files/News/InternalResource/70212_RecommendationsfortheFutureGovernmentRoleintheCoreSecondaryMortgageMarket.pdf;

Independent Community Bankers Association, “Housing Finance – What Should the New System Be Able to Do?” Testimony before the House Financial Services Committee April 14, 2010,

<http://financialservices.house.gov/Media/file/hearings/111/Printed%20Hearings/111-121.pdf>;

Michael J. Heid, Housing Policy Council (HPC), Testimony before the House Financial Services Committee, September 29, 2010,

<http://financialservices.house.gov/Media/file/hearings/111/Heid092910.pdf>;

Sheila Crowley, National Low income Housing Coalition, Testimony before the House Financial Services Committee, April 14, 2010,

<http://www.nlihc.org/doc/Testimony-of-Sheila-Crowley4-14-2010.pdf>; and Center for American Progress, “A

Responsible Market for Housing Finance”, December 2009

http://www.americanprogress.org/issues/2009/12/pdf/housing_finance.pdf

Appendix 1:

Definition of a Prime Loan

A prospective prime borrower needs to be qualified based on a demonstrated ability to repay the loan, a demonstrated willingness to meet his or her obligations, and sufficient equity to reduce the likelihood of default to a reasonable level.³⁹

We define *prime first mortgage loans* as loans with the following characteristics:

- Loans on properties occupied as a primary or secondary residence.⁴⁰
- Home purchase loans with a CLTV of 90 percent or less.^{41 42}
- Rate and term refinances with a CLTV of 80 percent or less for conventional loans with a maximum loan term of twenty-five years.⁴³
- Cash-out refinances with a CLTV of 75 percent or less for conventional loans with a maximum loan term of twenty years.⁴⁴
- Loans to borrowers with a demonstrated willingness to meet their obligations as represented by a FICO credit score of 660.⁴⁵
- Housing and total debt-to-income ratios of less than 33 percent and 38 percent, respectively.⁴⁶
- Underwritten based upon verified income, assets, and credit.⁴⁷
- If an adjustable-rate mortgage or balloon, an initial fixed rate for seven years or more, with the borrower qualified at the maximum rate permitted during the first seven years.
- If a prepayment fee is charged, it may not provide for a fee in excess of 3 percent of principal for the first year, 2 percent for the second, and 1 percent for the third.
- A loan with a CLTV greater than 80 percent has mortgage insurance down to at least 65 percent or a second mortgage of sufficient size so the LTV on the first mortgage is 65 percent or less.

³⁹ These represent the traditional Three Cs of mortgage risk:

Credit or willingness to pay—generally represented by evaluation of a credit report.

Capacity or ability to pay—generally represented by evaluation of income and liability information measured against housing and other debt ratios.

Collateral underlying the mortgage—generally represented by evaluation of amount and source of down payment information and an appraisal to determine the value of a property for lending purposes.

⁴⁰ In 1991, over 98 percent of Fannie’s loans met this standard. Data from Fannie Mae’s random sample review covering single-family acquisitions for the period October 1988–January 1992, dated March 10, 1992. Document contained in the authors’ files.

⁴¹ Ibid. In 1991, over 91 percent of Fannie’s home-purchase loans had a CLTV of 90 percent or lower.

⁴² To accurately evaluate risk, the combined loan-to-value ratio is used. This takes into account both the first and second mortgage and allows for the amount of down payment and borrower equity to be disclosed in a uniform manner and evaluated.

⁴³ Ibid. In 1991, over 93 percent of Fannie’s loans had a LTV 80% or lower.

⁴⁴ Ibid. In 1991, over 92 percent of Fannie’s loans had a LTV 75% or lower.

⁴⁵ Ibid. In 1991, over 98 percent of Fannie’s loans had one or no mortgage late payments at origination and 85 percent had two or fewer nonmortgage late payments at origination.

⁴⁶ Ibid. In 1991, over 90 percent of Fannie’s loans met this standard.

⁴⁷ Fannie stopped acquiring low-doc or no-doc loans in 1990. Freddie followed in 1991. See “Haste Makes . . . Quick Home Loans Have Quickly Become Another Banking Mess,” *Wall Street Journal*, July 5, 1991.

As demonstrated by footnotes 20–27, in 1991 the preponderance of conventional loans (defined as being Fannie eligible, other than by loan size) would have met this definition.

Prime loans should be eligible for a minimum risk-based capital requirement of 4 percent; loans that do not meet the prime standard would have a higher risk-based capital requirement.

Appendix 2:

Nonprime loans

As noted under principle 2, nonprime loans are inappropriate for inclusion in private MBS, covered bonds, and FHLB advances. This will mean that nonprime loans will have to be held in the portfolio of a bank or other leveraged entity.

Additionally, nonprime loans contained in the portfolios of levered entities such as depository institutions should be subject to a variable capital requirement that adjusts as the share of nonprime loans in the origination market changes.⁴⁸ This would be accomplished by setting capital requirements that automatically adjust as nonprime loans' share of the origination changes. Implementing this requirement necessitates tracking the quality characteristics of all mortgage loans. This will allow for a determination of the percentage of prime and nonprime loan originations entering the market on a quarterly basis.

Prime loans would be subject to a 4 percent capital requirement. The risk-based capital requirements for new nonprime loans placed in a depository institution's portfolio would be adjusted. For nonprime loans, when nonprime loans nationally comprise 25 percent or less of all mortgage originations the previous quarter, new nonprime loans placed in portfolio would be subject to an 8 percent capital requirement. If nonprime loans comprise more than 25 percent of all mortgage originations the previous quarter, the capital requirement on new nonprime loans placed in portfolio would be set at 30 percent of the nonprime percentage. For example, if the nonprime percentage were 30 percent, the capital level would be set at 9 percent. Likewise, if the nonprime percentage were 40 percent, the retention level would be set at 12 percent.

This countercyclical policy yields two results: increased capital as a cushion against loan losses and/or reduced originations of higher-risk nonprime loans to fuel an unsustainable boom.

⁴⁸ FHA and other social policy loans would be included in this calculation.

Appendix 3:

THE BASIC FACTS ABOUT YOUR MORTGAGE LOAN

Borrower: _____ Property address: _____

Lender: _____
Amount of loan: \$ _____, which is _____ % of the property's appraised value.
Your loan is for _____ years.
The type of loan you have: _____

Your beginning interest rate is _____%. This rate is good for _____ months/years. The rate and your payment can go higher by up to _____% on _____ and each _____ months after that.

One estimate of what your future rate could be, called the fully indexed rate, is _____%.
The maximum possible rate on your loan is _____%. You were qualified for approval using a rate of _____%.

THIS LOAN IS BASED ON YOUR MONTHLY INCOME OF \$ _____.

Your beginning rate = a monthly loan payment of \$ _____ = _____ % of your income.
-including taxes and insurance this is about \$ _____ = _____ % of your income.

The fully-indexed rate = a loan payment of \$ _____ = _____ % of your income.
-including taxes and insurance this is about \$ _____ = _____ % of your income.*

*This is called your fully indexed housing expense ratio.

Special factors you must be aware of:

- A prepayment fee of _____ must be paid if _____.
- A "balloon payment" of \$ _____ to pay off your loan will be due on _____.
- You do/do not have a loan with possible "negative amortization". If you do, make sure you really understand what this means. Start with the definition on p. 3.

Total "points" plus estimated other costs and fees due at closing are \$ _____.

FOR QUESTIONS CONTACT: Name: _____

Phone: _____ e-mail: _____

**See definitions of underlined terms and guidelines on pages 2-3.
DO NOT SIGN THIS IF YOU DON'T UNDERSTAND IT!**

Borrower Date

Authorized Signer of Lender Date

Borrower Date

The Basic Facts about Your Mortgage Loan

This form gives you the basic facts, but some mortgage forms may use terms not listed here. For a good, borrower-friendly information source, try the Mortgage Professor online (www.mtgprofessor.com), which includes detailed explanations of the technical mortgage terms in its glossary and much other helpful information.

Definitions and Guidelines Used in This Form

The *appraised value* is what a professional appraisal estimates the house could be sold for in today's market.

The *type of loan* determines whether and by how much your interest rate can increase. If it can, your monthly payments will also increase—sometimes by a lot. For example, in a thirty-year fixed rate loan, the interest rate is always the same. In a one-year ARM, it will change every year. Other kinds of loans have various patterns, but the interest rate may go up a lot. Make sure you understand what type of loan you're getting.

The *beginning interest rate* is the interest you are paying at the beginning of the loan. It is the rate which you will hear the most about from ads and salespeople. But how long is it good for and when will rates increase? In many types of loans, the rate can go up by a lot. You need to know.

The *fully-indexed rate* is one indicator of what can happen to your interest rate and your monthly payments. It is calculated by taking a defined "index rate" and adding a certain number of percentage points, called the "margin." For example, if the rate formula on your loan is the one-year Treasury rate plus 3 percent, and today the one-year Treasury rate is 5 percent, your fully-indexed rate is $5\% + 3\% = 8\%$. This will almost always be higher than your beginning rate.

The index rates are public, published rates, so you can study their history to see how much they change over time. If the index rate stays the same as today, the rate on your loan will automatically rise to the fully-indexed rate over time. Since the index rate itself can go up and down, you cannot be sure what the future adjustable rate will be. In any case, you must *make sure you can afford the fully-indexed rate*, not just the beginning rate, which is often called a "teaser rate" for good reason.

The *maximum possible rate* is the highest your interest rate can go. Most loans with adjustable rates have a defined maximum rate or "lifetime cap." You need to think about what it would take to make your interest rate go this high. How likely do you think that is?

Your *monthly income* means your gross, pre-tax income per month for your household. This should be an amount which you can most probably sustain over many years. Make sure the monthly income shown on this form is correct!

Your *monthly payment including taxes and insurance* is the amount you must pay every month for interest, repayment of loan principal, house insurance premiums, and property taxes. Expressed as a percent of your monthly income, this is called your housing expense ratio. Over time, in addition to any possible increases in your interest rate and how fast you must repay principal, your insurance premiums and property taxes will tend to increase. Of course, your monthly income may also increase. How much do you expect it to?

Your *fully-indexed housing expense ratio* is a key measure of whether you can afford this loan. It is the percent of your monthly income it will take to pay interest at the fully-indexed rate, plus repayment of principal, house insurance, and property taxes. The time-tested market standard for this ratio is 28 percent; the greater your ratio is, the riskier the loan is for you.

A *prepayment fee* is an additional fee imposed by the lender if you pay your loan off early. Most mortgages in America have no prepayment fee. If yours does, make sure you understand how it would work before you sign this form.

A "*balloon payment*" means that a large repayment of loan principal is due at the end of the loan. For example, a seven-year balloon means that the whole remaining loan principal, a very large amount, must be paid at the end of the seventh year. This almost always means that you have to get a new loan to make the balloon payment.

A "*loan with possible negative amortization*" means that in the years immediately after securing a mortgage loan, you can pay even less than the interest you are being charged. The unpaid interest is added to your loan, so the amount you owe gets bigger. The very low payments in early years create the risk of very large increases in your monthly

payment later. Negative amortization loans are typically advertised using only the very low beginning or “teaser” required payment, which is less than the interest rate. You absolutely need to know four things: (1) How long is the beginning payment good for? (2) What happens then? (3) How much is added to my loan if I pay the minimum rate? 4) What is the fully-indexed rate?

“Points” are a fee the borrower pays the lender at closing, expressed as a percent of the loan. For example, two points mean you will pay an upfront fee equal to 2 percent of the loan. In addition, mortgages usually involve a number of *other costs and fees* which must be paid at closing.

Closing is when the loan is actually made and all the documents are signed.

The *For Questions Contact* section gives you the name, phone number, and e-mail address of someone specifically assigned by your lender to answer your questions and explain the complications of mortgage loans. Don’t be shy: contact this person if you have any questions.

Finally, *do not sign this form if you do not understand it.* You are committing yourself to pay large amounts of money over years to come and pledging your house as collateral so the lender can take it if you don’t pay. Ask questions until you are sure you know what your commitments really are and how they compare to your income. Until then, do not sign

Appendix 4:

Relative Foreclosure Rates

The following two tables set forth data from the 2005 Federal Reserve study. The first⁴⁹ covers loans from 1994 and demonstrates that it was well documented in 1996 that as FICO scores go down and/or LTV increases,⁵⁰ the risk of foreclosure increases dramatically.

Table A4.1: Relative Foreclosure Rates by Credit Score Range

LTV	FICO <621	FICO 621–660	FICO >660
<=80%	26.9	7.9	1.0
>80%	47.6	15.3	3.3

The second covers both conventional and government fixed-rate loans from 1990 to 1993 and demonstrates that in 1996 it was well documented that as FICO scores decline, the risk of foreclosure increases dramatically for both types of loans.⁵¹ Common sense dictates that forcing conventional lenders and investors to emulate government (that is, FHA) lending could only lead to disaster.

Table A4.2: Relative Foreclosure Rates for Conventional and Government Loans by Credit Score Range

Loan type	FICO <621	FICO 621–660	FICO >660
Conventional fixed rate	28.5	7.3	1.0
Government fixed rate	45	12.8	3

These data date from the period before HUD began to increase affordable-housing requirements and encourage reductions in mortgage underwriting standards through the elimination of down payments, expansion of lending to credit-impaired borrowers, and other weakened lending standards. These efforts, taken pursuant to the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (GSE Act), forced the GSEs and the entire market to emulate the FHA's already high-risk lending, which got even riskier as the FHA further weakened its lending from the early 1990s forward.

⁴⁹ Supra. Federal Reserve, derived from table 6. The index sets the average foreclosure rate equal to one for loans with a borrower FICO score of more than 660 and an LTV of <=80 percent. Data are from Freddie Mac over the period 1994–95.

⁵⁰ The relationship between high-LTV and lower-LTV loans is understated by these data. In 1994, almost all of Freddie's loans had an LTV of 90 percent or less, with a small percentage having LTVs of 91–95 percent. Virtually none had an LTV >95 percent. As a result of HUD's mandates, Freddie (and Fannie) began acquiring 97 percent LTV loans in 1994 and 100 percent LTV loans in 2000.

⁵¹ Supra. Federal Reserve, derived from Table 2. The index sets the average delinquency rate equal to one for conventional fixed-rate loans. Data are from the period 1990–93.

Appendix 5:

FHA lending

From its creation in 1934, the FHA has been one of Congress's main tools to support low- and moderate-income single-family housing. Since its establishment in 1934, the FHA has led the entire market to ever-higher LTVs. The figures below⁵² show LTV trends over the last sixty years:

Figure A5.1: Postwar Trends in New Home Mortgage Loan-to-Value Ratios, 1947-67

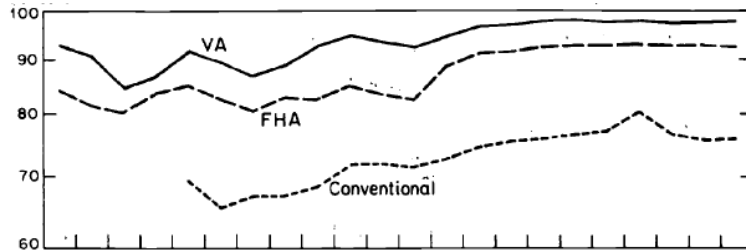


Figure A5.2: Postwar Trends in Existing Home Mortgage Loan-to-Value Ratios, 1947-67

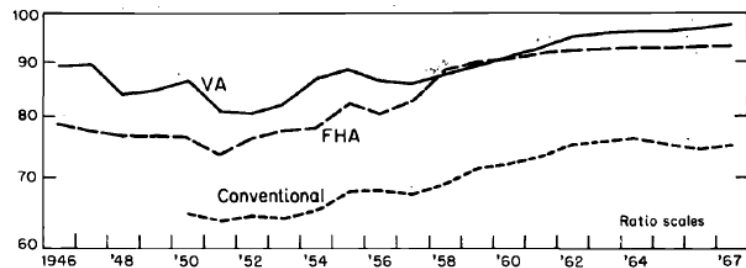
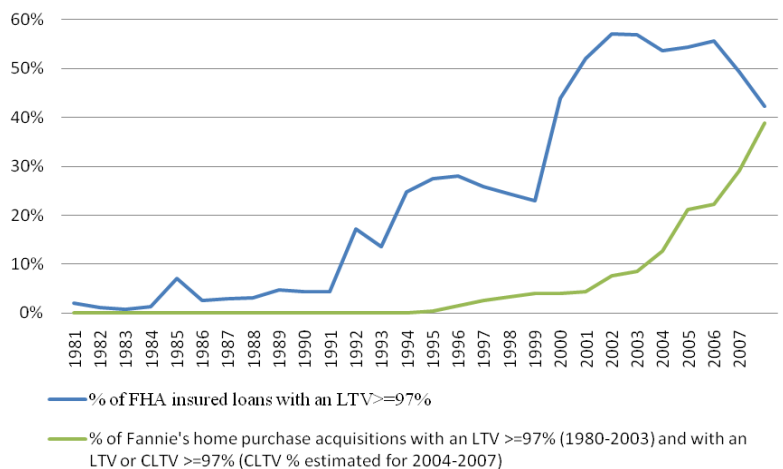


Figure A5.3: Trend of FHA and Fannie Loans with no Downpayments



⁵² Thomas N. Herzog, "History of Mortgage Finance with an Emphasis on Mortgage Insurance," Society of Actuaries, www.soa.org/library/monographs/finance/housing-wealth/2009/september/mono-2009-mfi09-herzog-history.pdf (accessed January 14, 2011)

Beginning its operations during the Great Depression, the FHA admirably performed its role through World War II and the postwar boom. As noted above, Congress periodically increased the FHA’s LTV limit or extended its maximum loan term (or both). This was presumed to come at no cost and was likely justified on the basis of the FHA’s previous experience. From 1934 through 1954, the FHA insured 2.9 million mortgages. For this period, during which house prices increased by 57 percent, the FHA paid claims on 5,712 properties for a cumulative claims rate of 0.2 percent⁵³ and had revenue of \$494 million and expenses of \$246 million.⁵⁴ The FHA’s apparent success encouraged Congress to periodically loosen underwriting standards (see table A5.1):

Table A5.1: FHA’s Transition to Unsustainable Lending

Year	Maximum LTV limit	Maximum loan term	Monthly payment*	Homeowner equity after five years (with no increase in house prices)	Mortgage payment-to-income ratio	Income needed to buy median-priced home*
1934	80%	20 years	\$670	30%	Not available	Not available
1938	90% ⁵⁵	25 years ⁵⁶	\$695	17%	Not available	Not available
1948	90%	30 years	\$660	14%	17% (average)	\$26,600 income/ \$44,600 home ⁵⁷
1956	95%	30 years	\$697	10%	Not available	Not available
1984	97%	30 years	\$712	8%	38% (maximum) ⁵⁸	\$23,000 income/ \$80,000 home ⁵⁹

* For comparison, all examples are based on the purchase of a \$100,000 home at the maximum LTV and term with an interest rate of 8 percent, except for median-home-price calculation, which uses applicable median home price.

⁵³ To put this in perspective, the FHA had twice this number of claims during the single month of October 2010. Federal Housing Administration, Department of Housing and Urban Development, “Monthly Report to the FHA Commissioner Department of Housing and Urban Development on FHA Business Activity,” October 2010, www.hud.gov/offices/hsg/rmra/oe/rpts/com/10oct.pdf (accessed January 14, 2011).

⁵⁴ . Supra., Herzog and Earley

⁵⁵ Ibid.

⁵⁶ Ibid.

⁵⁷ Median price data for 1950. See US Census Bureau, “Census of Housing,” www.census.gov/hhes/www/housing/census/historic/values.html (accessed January 14, 2011).

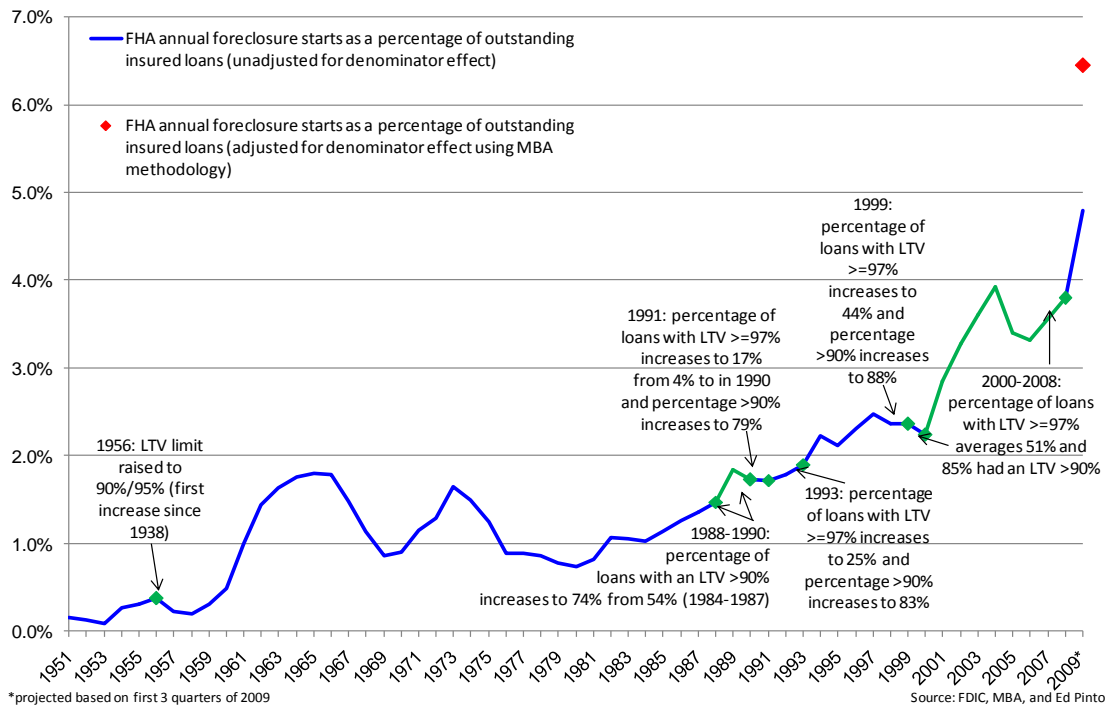
⁵⁸ Stephen Moore, “How Congress Can Diffuse the Federal Housing Time Bomb,” Heritage Foundation, July 29, 1986, 7, www.policyarchive.org/handle/10207/bitstreams/9281.pdf (accessed January 14, 2011).

⁵⁹ U.S. Census Bureau, “Median and Average Sales Prices of New Homes Sold in United States,” www.census.gov/const/uspriceann.pdf (accessed January 14, 2011).

As seen from table A5.1, the FHA started out with both a substantial down payment (20 percent) and loan amortization, so by the end of the first five years of the loan, the homeowner had equity of 30 percent. Further, debt ratios were low. In the late 1940s, the FHA had an average mortgage-payment-to-income ratio of 17 percent.⁶⁰ By the early 1980s, a buyer would only have equity of about 8 percent after five years, and mortgage payments had about doubled relative to income.⁶¹ Reliance on house-price inflation and lending to highly leveraged borrowers had become necessary parts of FHA’s financing structure.

As figure A5.4 demonstrates, there was a cost. As FHA took on more risk, foreclosures increased.

Figure A5.4: FHA’s Increasing LTVs on Annual Foreclosure Starts as a Percentage of Insured Loans



By 1961, the FHA was experiencing a foreclosure start rate of 1.00 percent per year—over six times the rate in 1951.⁶² Equally disconcerting was the fact that the private sector, in order to compete, followed the FHA’s lead by increasing LTV, loan-term, and debt ratios.

⁶⁰ John P. Herzog and James S. Earley, *Home Mortgage Delinquency and Foreclosure* (Cambridge, MA: National Bureau of Economic Research, 1970).

⁶¹ Stephen Moore, “How Congress Can Diffuse the Federal Housing Time Bomb.”

⁶² This increase led *Time* magazine to observe: “Homeowners of a new and unattractive breed are plaguing the Federal Housing Administration these days. Known as ‘the walkaways,’ they are people who find themselves unable to meet their mortgage payments—and to solve the problem simply move out their belongings at night, drop their house key in the mailbox and disappear.” Credit: Beware of the Walkaways,” *Time*, July 27, 1962, www.time.com/time/magazine/article/0,9171,827500,00.html (accessed January 14, 2011).

As a result of the FHA's risky underwriting standards, its claim rate has been excessive for many decades. Over a thirty-five-year period (1975–2009), the FHA's cumulative claim rate averaged 10.5 percent, and over 1992–2009 it averaged 10 percent. Even during the boom years of 1995–2003, the cumulative claim rate still averaged nearly 8 percent. During bust periods (1980–85 and 2005–2008), it averaged 18 percent—over two times the rate in good times. For 2010–17, the FHA has projected an 8 percent average claim rate even with an expected 33 percent increase in home prices over 2011–20.⁶³ Relying on home-price inflation to attain a default rate of nearly one in ten is not sustainable lending.

⁶³ FHA Actuarial Studies for 2010 and 2000.

Appendix 6:

What Others Have Said about Reforming the Housing Finance Market

On September 22, 2010, former Federal Reserve chairman **Paul Volcker** was quoted as follows:⁶⁴

“The former Federal Reserve chairman [and special adviser to President Obama] said the mortgage industry is dysfunctional and a ‘creature of the government’ that needs reform. . . . He would want to avoid a ‘hybrid’ institution that is ‘private when things are going well and public when things are going badly.’”

In a June 2010 speech, FDIC chair **Sheila Bair** stated:

“The financial crisis was triggered by a reckless departure from tried and true, common-sense loan underwriting practices.”

In comments made at a September 29, 2010, House Financial Services Committee hearing, Chairman **Barney Frank** said:

“When you start subsidizing homeownership, you’re getting into trouble. When people clearly can’t afford it, you are imposing on them an obligation going forward that was shaky from the beginning.”

“Acknowledge as a mistake the setting up of private corporations, Fannie Mae and Freddie Mac, but infusing into their business decisions a social component so that they, because of the [affordable housing] goals, we could never be sure what the basis was.”

“[In terms of future entities] I would be opposed to any mandate to them. They will be making business decisions.”

In an August 2010 interview, Representative **Frank** stated:⁶⁵

“I hope by next year [2011] we’ll have abolished Fannie and Freddie . . . 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.” He then added, “I had been too sanguine about Fannie and Freddie.”

Representative **Jeb Hensarling** in an October 2010 interview stated:⁶⁶

⁶⁴ Daniel Bases and Kristina Cooke, “Obama aide Volcker says mortgage market reform crucial,” Reuters, September 22, 2010.

⁶⁵ Larry Kudlow, “Barney Frank Comes Home to the Facts.”

⁶⁶ Stacy Kaper, “Hensarling’s Aggressive Agenda Starts with Housing Finance Reform,” *American Banker*, October 27, 2010, www.americanbanker.com/issues/175_206/jeb-hensarling-1027690-1.html?ET=americanbanker:e4810:1353098a:&st=email&utm_source=editorial&utm_medium=email&utm_campaign=AB_Daily_Briefing_102610 (accessed January 14, 2011).

“In general, we’ve had a lot of federal policies that incented, strong-armed, or cajoled financial institutions to loan money to people to buy a home that they could not afford to keep.”

In an October 2010 interview, Representative **Hensarling** stated:⁶⁷

“And I think that frankly a lot of the housing policies that have taken place over both successive Republican and Democratic administrations are going to have to be re-examined.”

In an October 2010 interview, Representative **Hensarling** stated:⁶⁸

“Slowly but surely, you ratchet down their [Fannie and Freddie’s] conforming loan limits. Slowly but surely, you ratchet up their capital standards to that of a well-capitalized bank. You slowly but surely increase the down-payment requirement and you allow the private marketplace to come into those areas where Fannie and Freddie on an ongoing basis, begin to retreat so that a competitive market can begin to come in. A private market can’t get started as long as there is a government guarantee for mortgage debt, whether implied or explicit. No one is going to compete with Uncle Sam—who’s got a printing press, who can print money and can put untold trillions of liability exposure on the taxpayer. Nobody is going to compete with that.”

In an October 2010 interview, Representative **Hensarling** stated:⁶⁹

“My principles are I want to err on the side of competitive markets that have disclosure and empower consumers with the information they need to make intelligent choices.”

“I believe housing should be part of the social safety net, but I want it designed for those who potentially are too old, too disabled, too young to help themselves. . . . And whatever we do, it probably ought to be done through an FHA-like structure. But it has to be actuarially sound and it needs to be on budget.”

In comments made at a September 29, 2010, Financial Services Committee hearing, Representative **Ed Royce** said:

“The US is the only country with government backed mortgage insurance, government backed MBS guarantees, and GSEs.”

“The mortgage finance system of tomorrow must be based, the lion’s share of it, on private capital, private investment.”

⁶⁷ Ibid.

⁶⁸ Stacy Kaper, “Hensarling’s Aggressive Agenda Starts with Housing Finance Reform.”

⁶⁹ Ibid.

In an October 2010 interview, Representative **Spencer Bachus** stated:⁷⁰

“Using taxpayer money to subsidize the mortgage market is an addiction, and like all addictions it can’t be cured overnight. There will be a reasonable transition period over a number of years to allow the private market to develop.”

In comments made at a September 29, 2010, House Financial Services Committee hearing, Representative **Randy Neugebauer** said:

“We can have a robust housing finance market without putting the taxpayers at risk.”

Edward DeMarco, acting director of the Federal Housing Finance Agency, advised caution in September 2010 testimony:⁷¹

“To put it simply, replacing [Fannie and Freddie’s] ‘implicit’ guarantee with an explicit one does not resolve all the shortcomings and inherent conflicts in that model, and it may produce its own problems.”

“First, the presumption behind the need for an explicit federal guarantee is that the market cannot evaluate and price the tail risk of mortgage default. . . . [Is there] reason to believe that the government will do better? If the government backstop is underpriced, taxpayers eventually may foot the bill again.”

“Second, if the government provides explicit credit support for the vast majority of mortgages in this country, it would likely want a say with regard to the allocation or pricing of mortgage credit for particular groups or geographic areas.”

“Third . . . explicit credit support for all but a small portion of mortgages, on top of the existing tax deductibility of mortgage interest, would further direct our nation’s investment dollars toward housing.”

In testimony before the Financial Crisis Inquiry Commission charged with investigating our latest financial crisis, **Warren Buffett** made these observations about the power of rising prices to mesmerize virtually all concerned:⁷²

“Rising prices and discredited Cassandras from the past blunt the sensitivities and judgment of even people who are very smart. A home is a sound investment . . . and if you believe house prices are going to go up next year, you are going to stretch to buy one this year, and the world enabled people to stretch. After awhile, rising prices became their own rationale.

⁷⁰ Sean Lengell, “GOP Targets Mortgage Bailouts,” *Washington Times*, November 21, 2010.

⁷¹ *Testimony of Edward DeMarco, Before the House Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises*, 111th Cong. (September 15, 2010).

⁷² The original source for this quote was

<http://www.cspan.org/Watch/Media/2010/06/02/HP/R/33689/Financial+Crisis+Inquiry+Commission.aspx>, however this link is no longer working. Much of Mr. Buffett’s remarks may be found at:

<http://www.investingcontrarian.com/index.php/financial-news-network/warren-buffett-at-the-financial-crisis-inquiry-commission/>.

People decided if buying one house is a good idea, then buying three houses is a good idea. Buying a house you can afford is a good idea, then buying a house you can't afford is a good idea because it is going to go up in price. And people who lent money said it really didn't make any difference if the guy's lying about his income. If the house goes up in price, we'll get our money back anyhow. So rising prices are a narcotic and affect the reasoning power up and down the line."