

REFORMING U.S. HOUSING FINANCE

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The views expressed by the author are his own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

Introduction

My position on the current stance of our nation's monetary policy is well known, especially to those who closely follow the Federal Reserve. The Federal Open Market Committee has met seven times this year, and at each of those meetings I have cast a dissenting vote against the majority opinion of keeping the federal funds rate target at its current level near zero for an "extended period."

I realize that advocating an interest rate increase is not the best applause line at a Realtors' conference. However, I believe that moving rates modestly off of zero, where they have been since December 2008, still represents highly accommodative monetary policy. More importantly, such action is necessary if we are to ensure a more stable economy that can thereby foster a more sustainable housing market.

How Can We Revive Housing?

We have all suffered through the worst collapse in housing prices since the 1930s, and the situation we face will not be easily corrected.

The housing collapse can be characterized as a classic asset-price bubble spurred by low interest rates, easily accessible and often-unsound financing, over-optimism about housing price trends, and a high—and difficult to control—level of subsidies that flowed into housing. Although we may have experienced a few exceptional years of housing activity, those years do not come close to making up for the economic recession, foreclosures, erased wealth and slow recovery that we now are experiencing.

Given this experience, the question that now confronts us is, “What can we do to create more stable housing markets and lessen the boom-bust cycles in housing?” These cycles have unfortunately become all too familiar over the past few decades.

Some argue that our housing and mortgage markets will not recover in a timely fashion without extensive public support. Among the suggested solutions are expanding Federal Housing Administration lending and the role of the Federal Home Loan Banks and allocating whatever funds are needed to bring the two housing agencies, Fannie Mae and Freddie Mac, back to their pre-crisis role for housing. Other ideas include a renewal of tax credits for home purchases and more extensive programs for mortgage restructurings. From the Federal Reserve, some want a continuation of near-zero interest rates for an extended period and greater investments in mortgage instruments.

In sharp contrast to that view, others suggest that the financial crisis has exposed a number of critical flaws in our housing policies and mortgage finance system that call for a significant “re-look” at how we finance this industry. For instance, Paul Volcker, who was chairman of the Federal Reserve during a portion of the 1980s real estate crisis, recently described the U.S. mortgage industry as “dysfunctional” and a “creature of the government” that needs reform.

The options seem to fall out to either rebuilding a system backed by extensive public support, subsidies and other protections, or build a new framework that returns housing finance to greater reliance on private market forces.

I support a policy path that returns the housing industry toward greater market discipline and greater long-run stability. This path requires a greatly reduced role for governmental intervention and public subsidies that have distorted the market over recent decades. The

American public, including aspiring homeowners and those of you employed in the housing industry, might be best served, over time, by reducing or removing these subsidies as part of our national policy.

There are several factors that argue for making such a change in policy. First, the crisis clearly shows that a mortgage finance system based on expanding the incentives and opportunities to take on more debt with little equity places households at significant financial risk and creates unsustainable trends in housing expansion.

Second, such policies create harmful distortions within the economy, and they are enormously expensive in terms of both their explicit and implicit costs, to both taxpayers and homeowners, especially when things go badly. Many of the subsidies directed toward housing have been extremely inefficient, with other parties capturing most of the benefits rather than homeowners.

Moreover, with the growing federal budget deficits and the many interests that will be intensely competing for public funds, it is unrealistic to expect that all can be accommodated or that housing can continue to command the same portion of public funds and levels of taxpayer support and exposure. In brief, housing policy is badly flawed, and today's budget environment requires reform.

Fix Freddie and Fannie

What specific steps should we take? The first and most obvious step is to reform the two housing finance vehicles of Fannie Mae and Freddie Mac. These two institutions were responsible for more than half of all U.S. mortgages passed through the system at the height of the housing boom. These government-sponsored enterprises were assigned goals around

affordable housing that contributed dramatically to the growth in subprime credit and the decline in lending standards that led to the crisis. Fannie and Freddie clearly fit the pattern of what Paul Volcker said we must avoid: “Private when things are going well and public when things are going badly.”

Several studies have found that the various subsidies received by Fannie and Freddie have done little to lower mortgage rates. Instead, the vast majority of such benefits accrued to Fannie and Freddie’s stockholders or was used to gain political favor. For example, only two months before Fannie Mae and Freddie Mac were put into conservatorship in September 2008, media accounts detailed how both had made the list of Washington’s top 10 lobbying spenders over the previous decade. Together, they had spent a total of \$170 million.¹ At that time, Fannie employed 51 lobbyists and Freddie paid 91, with both counting former members of Congress among their hired guns. This was only two years after the Federal Election Commission levied a \$3.8 million penalty against Freddie related to charges it was illegally involved in 85 political fundraisers.

Considering the high level of political activism on the part of these GSEs, it should not surprise you to learn that both Fannie and Freddie are considered “heavy hitters” on the Center for Responsive Politics’ website, OpenSecrets.org, which provides a wide range of data on money’s influence on U.S. elections and policy. That designation means that both are among the biggest donors to federal-level politics since 1989.

So, while Fannie and Freddie have spent millions on lobbying and building influence in Washington, their losses could cost taxpayers as much as \$363 billion, according to recent estimates—and those are just the direct losses. The overall losses that could be attributed to the GSEs are likely to be several multiples higher when we consider that without their implied

¹ *USA Today*, July 17, 2008.

“federal guarantee” and related incentives around risk, the markets might have been far more cautious and the financial crisis far less prolific. More stunning perhaps, had these institutions been held to stricter financial standards, far fewer households would have suffered the tragedy of foreclosures, the lost home equity and the loss of personal savings and wealth that today continues to hold back our economic recovery.

Given the costs and market distortions these government-supported institutions brought with them, we should be confident that they should not be allowed to operate in the future as they have in the past. We cannot afford to ignore that through their use of implicit government funding guarantees, they held a significant competitive advantage in the marketplace, and that this in turn encouraged excessive risk on their balance sheets, with tragic outcomes.

Given past errors, how might we approach the need for some modest support for future financing within the housing industry? I see two basic options.

First, if we judge that some public support is needed, we could establish public entities that focus solely on the securitization of conventional, conforming mortgages with strong underwriting standards, tight public oversight and balance sheets limited to holding amounts necessary for warehousing loans to be securitized. This makes the government a conduit only, facilitating the flow of capital but not providing the implicit guarantees on funding and assets held that contributed to this crisis. The market remains the final arbiter of standards and funding.

A second option would be to give private entities sole authority to securitize pools of conforming mortgages—similar to what is now done with jumbo mortgages. If the Congress was disposed to provide some favor to housing, a federal guarantee could be given to certain securities backed by mortgages meeting strict conforming loan standards. However, such favored status should be based on some limiting factor, such as need or special purpose.

Either of these two options would address many of the problems associated with Fannie and Freddie in this crisis and would create a more transparent and competitive marketplace. The latter option involving privately owned entities would offer the additional benefits of greater market discipline and insulation from political influence and control.

Enforce Sound Lending Standards

Regardless of these actions, we must as a nation insist on the return to sound real estate lending standards. We know today that countries that avoided the worst of this most recent real estate meltdown did a better and more consistent job in maintaining an effective and consistent set of standards for loan-to-value and debt-to-income ratios. Some countries, such as Canada, even tightened mortgage lending requirements when real estate markets heated up. In the United States, the opposite occurred.

While sound credit standards are a key responsibility of individual lenders, public policy also played an important role in the deterioration of loan quality in the United States. This occurred largely through public efforts to promote and subsidize homeownership and increase access to housing credit. During the crisis, politicians, regulators and market participants were singled out for blame. In reality, it was a group effort.

In the years leading to this most recent crisis, a common theme emerged at all levels: Households can accommodate more debt relative to income. A report titled *The 1994 National Homeownership Strategy: Partners in the American Dream* stated: “Financing strategies fueled by the creativity and resources of the private and public sectors should address...financial barriers to homeownership [and]...reduce downpayment requirements and interest costs by making terms more flexible.” In other words, the key to homeownership from a political

perspective is to promote more creative and flexible lending standards, or what, in hindsight, we might more correctly call high leverage.

This political desire for creative and flexible lending was hardly new in 1994, though. It was also a central fixture in the real estate collapse of the 1980s. A Senate report on a 1982 legislative provision to remove national bank loan-to-value limits on real estate lending provides a powerful insight into the causes of financial crises. According to this report, the purpose of the legislative change was “to provide national banks with the ability to engage in more creative and flexible financing, and to become stronger participants in the home financing market.”

Although creative and flexible financing might remain a goal in housing, sound lending standards cannot be ignored if we are to have sustainable housing growth. With this in mind, the Federal Reserve in 2008 revised rules implementing the Home Ownership and Equity Protection Act. These rules simply prohibit lenders from making loans without considering a borrower’s ability to repay the loan from income and assets other than a home’s value. Who would have thought it necessary to write rules that are otherwise nothing but common sense?

We should also take a closer look at the loan-to-value guidelines that depository institutions are required to follow in making real estate loans. We should review guidelines to ensure they are adequate, and we should apply them equitably to other lenders. Other lending provisions, subsidies and public policies directed toward the housing sector and home financing also need to be examined. These would include the risk weights for mortgage loans and mortgage-backed securities under the Basel capital requirements, state and federal tax deductions for mortgage interest, reliance on credit rating agencies’ assessments of mortgage-backed securities, and the wide variety of other public policies related to housing. Given current housing

conditions and the way a number of subsidies have become embedded in our housing system, some policy reforms would have to be phased in gradually and after markets have recovered.

A key point in reviewing U.S. housing finance policies should be to consider whether they encourage homeownership in a cost-effective manner without putting homeowners at unacceptably high financial risk. The 2005 President's Advisory Panel on Federal Tax Reform, for instance, concluded that the federal tax deduction for mortgage interest provided an "incentive to take on more debt," involved large subsidies that encouraged "overinvestment in housing" and was "not shared equally among all taxpayers," with higher-income households receiving "a disproportionate benefit." Accordingly, the panel recommended replacing the deductions with tax credits and placing a cap on the benefits as a means of distributing the benefits more evenly and limiting the incentives to take on excessive amounts of debt.

With regard to promoting housing through interest rate policies, I have many times publicly expressed my views about the dangers of using monetary tools and the Federal Reserve's balance sheet to pursue low interest rates and fund mortgage-backed securities. The only additional point that I would repeat is that for home financing to follow a path that is sustainable over time, the Federal Open Market Committee must begin taking steps to normalize monetary policy.

Conclusion

Economists Hyman Minsky, Charles Kindleberger, and, more recently, Carmen Reinhart and Kenneth Rogoff have all written extensively about how high credit growth and the financial imbalances that develop during economic upturns sow the seeds for future financial instability. In a similar manner, a Norwegian economist looked at banking and financial crises in Norway

going all the way back to the early 1800s. She found that every major crisis was preceded by a rapid run-up in real housing prices. Consequently, it is apparent that unsustainable trends in housing prices and home financing have been a major contributor to financial crises.

The United States stands virtually alone in its use of GSEs and significant subsidies to promote homeownership. Fannie Mae, Freddie Mac and their political supporters have long attempted to justify this system by saying that “American housing finance is the envy of the world.” Few would believe that today.

It is time for a significant change. We must move toward a system with fewer subsidies and misdirected incentives. Furthermore, to ensure accountability, any housing subsidies that we decide to keep should be made explicit, voted on transparently and carefully targeted to the intended beneficiaries: potential homeowners most in need and for whom such support will bring success.

Many of you might question whether a system with greatly reduced subsidies will work. A partial answer to this question can be found in international comparisons. A recent study, for instance, found that in terms of homeownership rates, the United States ranked only 17th out of 26 economically advanced countries. Many countries have achieved higher homeownership rates without—and perhaps because they don’t have—many of the special privileges of U.S. housing finance, such as GSEs, minimal down payments, 30-year fixed-rate loans and mortgage interest tax deductions. To this list, we could also add non-recourse debt instruments, government promotion of “creative and flexible financing,” the ability to prepay loans, affordable housing goals and similar government housing programs.

In making these remarks, I am not suggesting we do away with all support for housing. I am saying it is time for change.