Anthony B. Sanders[1]
Oral Testimony
House Financial Services Committee
March 23, 2010
Hearing on "Housing Finance-What Should the New System Be Able to Do?
Part I-Government and Stakeholder Perspectives"

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Mr. Chairman, Ranking Member Bachus, and members of the committee:

The federal debt stands at $8 trillion. But the Fannie Mae, Freddie Mac, and Federal Home Loan Bank debt stands at $8 trillion as well. This combined debt load for the U.S. is $16 trillion and represents 110% of our gross domestic product (see figures 1 and 2). This "Grecian Formula" of debt issuance to fund housing goals is not sustainable. We simply have too much leverage in the housing finance system.

To make matters worse, the federal government controls 95% of residential mortgages made with FHA insurance or Fannie Mae and Freddie Mac loan purchases. Stated differently, our financial institutions will not originate residential mortgages unless the federal government insures or purchases them.

We need to take immediate action to get the financial institutions and the investment community back in the game and wind down the federal government's involvement. We have affordable housing missions at HUD, at Fannie and Freddie through affordable housing goals, at financial institutions through the Community Reinvestment Act, and numerous other federal, state, and local programs. Given the massive supply of vacant housing on the market, the shadow inventory of foreclosed houses at financial institutions, and the multifamily vacancy rates, perhaps it is high time that we consolidate the affordable housing missions under one tent.

Historically, the nation's affordable housing mission has been under HUD. Hence, I would recommend that any federal affordable housing mission be housed there. But the FHA, our low-to-moderate income mortgage insurance entity, is woefully antiquated in terms of technology and is in desperate need of modernization. Thus my first recommendation is a dramatic overhaul and modernization of the FHA.

My second recommendation is to slim down Fannie and Freddie's role in the housing market. We can begin by 1) removing their affordability housing mission, 2) unwinding the retained portfolios at an accelerated pace, and 3) toughening the regulatory oversight of Fannie and Freddie by moving it to a stronger FHFA.

My third recommendation is to pass legislation governing a covered bond market (similar to the market that exists in Denmark) and begin with the jumbo mortgage market. Covered bonds potentially provide an excellent vehicle to fund the residential and commercial mortgage markets going forward.
My fifth recommendation is to repair the securitization model that is already in existence. This can be done by requiring lenders to retain a first loss piece on their balance sheet.

My fourth recommendation is to repair the securitization model that is already in existence. Having lenders retain "skin in the game" of at least 5% of the loans originated and sold is a good start. Our recent downturned in housing teaches us that 5% would be grossly insufficient to cover future

downturns in housing prices. One the other hand, a private securitization market should be a "buyer-beware" market, so "skin in the game" would then be pointless.

Lastly, we have to return to a 10–20% or more down payment standard for mortgage lending (and 10% in the FHA programs). The housing price bubble of the last decade was fueled mostly by low interest rates combined with low down payment mortgages (and "exotic" mortgages such as pay option ARMs). The much maligned subprime market was a convenient scapegoat for the crisis. Had lenders and the GSEs adhered to a 10–20% down payment standard, there would not have been a bubble in the first place. And the subprime borrowers would not have defaulted in such numbers had the bubble not burst.

Mr. Chairman, thank you letting me share my comments and suggestions with you and the committee.

Thank you.

Appendix: Full Report of Anthony B. Sanders
Also available at http://mason.gmu.edu/~asander7/

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How We Got Here

Our total federal debt as of the end of 2009 is presented in figure 1. This figure includes both on-balance sheet federal debt at $8 trillion and "off-balance sheet" federal debt in the form of Fannie Mae, Freddie Mac, and Federal Home Loan Bank debt of an additional $8 trillion.

In figure 1 I plot the federal debt since 1990 and the GSE and agency debt. The big turning was the third quarter of 1999 when GSE and agency debt passed the federal debt in terms of size. From 1999 to the end of the Clinton Administration, GSE and agency debt grew 57%. GSE and agency debt grew dramatically until mid-2003 and then began growing their debt again in 2007. In fact, until the dramatic spike in federal debt in 2008, the federal debt grew 36% over a nine-year period from 1999–2007. GSE and agency debt grew a staggering 114%.

Before 1999, house prices in the U.S. were relatively flat although the GSE/agency debt was growing (although slowly compare to growth rates in 1999–2003). As you can see in figure 3, the Case-Shiller Index of 10 cities began to grow dramatically and in closely in line with GSE/agency debt expansion. While GSE/agency debt was relatively flat from 3rd quarter 2003 to 3rd quarter 2005 (a two-year hiatus), the debt issuance began to heat up again in 3rd quarter 2005. The lull in the GSE/agency debt issuance reflects the rise in the private label securitization market during 2003–2005 where the GSEs lost market share to the jumbo, subprime, ALT-A, and related mortgage markets. However, the GSEs began to enter the game again and actually provided liquidity to the subprime and ALT-A markets by either purchasing ALT-A loans or investing in subprime ABS. By the end of 2007, housing prices began falling off a cliff and the GSE/agency debt began to really accelerate again. Hence, we are up to $8 trillion in GSE/agency debt at the end of 2009.

In addition to the staggering debt load and leverage in the residential mortgage market, Fannie Mae and Freddie Mac are chartered by Congress with a mission to provide liquidity, stability, and affordability to the U.S. housing and mortgage markets. As can be seen in figure 4, having housing prices rise over 200% in just over 10 years is hardly in line with providing affordable housing. They did, however, provide benefits to those who purchased a house at the beginning of the housing run-up. Unfortunately, millions of households are suffering from the bubble burst in terms of lost asset value and foreclosure. Was letting the bubble grow worth the pain that it caused?

Government Dominance of the Residential Mortgage Market

To make matters worse, the federal government controls 95% of residential mortgages made with FHA insurance or Fannie Mae and Freddie Mac loan purchases. It is downright dangerous to have so much leverage and credit risk concentrated in Fannie, Freddie, and the FHA. This also means that our financial institutions will not originate residential mortgages unless the federal government insures or purchases them.

We need to take immediate action to get the financial institutions and the investment community back in the game and wind down the federal government's involvement. We have affordable housing missions at HUD, at Fannie and Freddie through affordable housing goals, at financial institutions through the Community Reinvestment Act, and numerous other federal, state and local programs. Given the massive supply of vacant housing on the market, the shadow inventory of foreclosed houses at financial institutions and the multifamily vacancy rates, perhaps it is high time that we consolidate the affordable housing missions under one tent.

Recommendation 1: Modernize the FHA

Historically, the nation's affordable housing mission has been under HUD. Hence, I would recommend that any federal affordable housing mission be housed there. But the FHA, our low-to-moderate income mortgage insurance entity, is woefully antiquated in terms of technology and is in desperate need of modernization. Thus my first recommendation is a dramatic overhaul and modernization of the FHA.

The FHA has an aging information technology infrastructure that struggles to keep up with the volumes of transactions that are being managed today. Their antiquated IT infrastructure makes it difficult to properly mitigate risks. Of course, the FHA is woefully understaffed in certain areas and the federal hiring process really hinders their ability to attract better talent.

The FHA is reliant on Congress for virtually any proposed rule or legislative change. Practically everything the FHA does requires a proposed rule or legislative change. For example, it takes a minimum of five months to modify any rule or change in policy. This means that if the FHA observes high default rates in a certain area (such as down payment buy downs from 3.5% to 0%), it takes them a minimum to five months to change that policy (and that assumes that HUD and Congress agree to it). The FHA averaged somewhere in the neighborhood of 1.6 million loans last fiscal year, or about 133,000 per month. If 10 to 20% of these loans were the risky product that the FHA would like to stop, that exposes the FHA to potential losses of $2 to $4 billion in losses.

Seller-funded down payment assistance loans are a perfect example of problems facing the FHA. This product was authorized in the National Housing Act which makes it legislatively authorized. You would think the FHA would have the discretion to kill the product when they realized these loans were 3 to 4 times more likely to default. In fact, despite being a small percentage of their book of business, these loans were responsible for approximately 35% of their losses.

Recommendation 2: Slim Down Fannie Mae and Freddie Mac

My second recommendation is to slim down Fannie and Freddie's role in the housing market. This can be done by 1) removing the affordability housing mission, 2) reduce their conforming loan cap and also introduce a floor so as to not compete with the FHA program, 3) unwind the retained portfolios at an accelerated pace until the retained portfolios are near zero, 4) toughen the regulatory oversight of Fannie and Freddie by moving it to a stronger FHFA, 5) abandon their private/public structure moving them toward private companies without a federal government debt guarantee, and 6) restrict their loan purchases to their previous core 10–20% down payment, 30 year fixed-rate mortgages and plain, vanilla ARMs. In addition,

1) Given that aggregate taxpayers are on the hook for the 65% of the population that own homes, of which approximately 70% were GSE loans, it is not really clear why the renters should be subsidizing the owners. If Fannie/Freddie were privatized, rates go up by something like 100 basis points, but taxpayers would no longer short the put (bear the risk).

2) A risk-sharing program, where the originating entity retains equity risk on the loan, (first loss such as 5–10% of loan amount), and the government insurance provides mezzanine or catastrophic risk at the asset level and counterparty risk at all levels. That is, the lender has a first loss on the loan, the loan gets government wrap, and the buyer of MBS only faces the government.

3) A program more similar to the government control of airwaves could be used for the guaranty. Government would auction off the right to insure *x* billion loans for *y* years. This would consolidate lending to larger parties and monetize the insurance fee as current income for the government. The loan originator, subject to stringent approved underwriting, delivers product with a pre-wrap certificate. This underwriting process would be similar to FHA loans today (after modernization, of course).

4) Regarding the retained portfolio, I would take their portfolio and divide into three tranches: the lower-quality loans, the loans that are outside of a narrow definition of conforming loans (for example, second homes or higher-priced homes), and what a narrow mandate might support (traditional, high-quality, first-lien loans). Securitize the low-quality and nontraditional loans. Establish a narrow mandate, recapitalize them and remove all subsidies and future guarantees. As part of the recapitalization, impose a narrow mandate until they repay the Treasury.

Recommendation 3: Introduce Covered Bonds as an Alternative

My fourth recommendation is to pass legislation governing a covered bond market (similar to the market that exists in Denmark) and begin with the jumbo mortgage market. Covered bonds potentially provide an excellent vehicle fund the residential and commercial mortgage markets. Specifically, covered bonds solve some of the problems found in the securitization model, such as keeping loans with the lender so that they are easier to modify in case of further economic downturns. Covered bonds would allow financial institutions to get back in the lending game since new loans could be kept on balance sheet, but bonds issued against those assets. As long as the assets (loans) are high quality and have transparency, the covered bond market should provide a viable competitor to Fannie/Freddie. I would also recommend a covered bond model that includes less than prime loans with 20% down payment or more. Neither of these covered bond programs should carry a guarantee.

Recommendation 4: Repair the Securitization Model

My fifth recommendation is to repair the securitization model that is already in existence. Having lenders retain "skin in the game" of at least 5% of the loans originated and sold is a good start. Our recent downturned in housing teaches us that 5% would be grossly insufficient to cover future downturns in housing prices. One the other hand, a private securitization market should be a buy beware market, so "skin in the game" would then be pointless. Concerning subprime securitization, I support the private sector in originating and selling/securitizing loans to subprime borrowers. On the other hand, I am concerned about the temptation to open the low down payment, exotic mortgage fountain again. Having borrowers have skin in the game (say 10%–20% for subprime and 10% for lower risk borrowers/mortgage type) may be an appropriate fix.

Recommendation 5: Return to 10-20% Down payment standards

Lastly, we have to return to a 10–20% or more down payment standard for mortgage lending (and 10% in the FHA programs). The housing price bubble of the last decade was fueled mostly by low interest rates combined with low down payment mortgages (and "exotic" mortgages such as pay option ARMs). The much maligned subprime market was a convenient scapegoat for the crisis. Had lenders and the GSEs adhered to a 10–20% down payment standard, there would not have been a bubble in the first place. And the subprime borrowers would not have defaulted in such numbers had the bubble not burst.

Figure 1

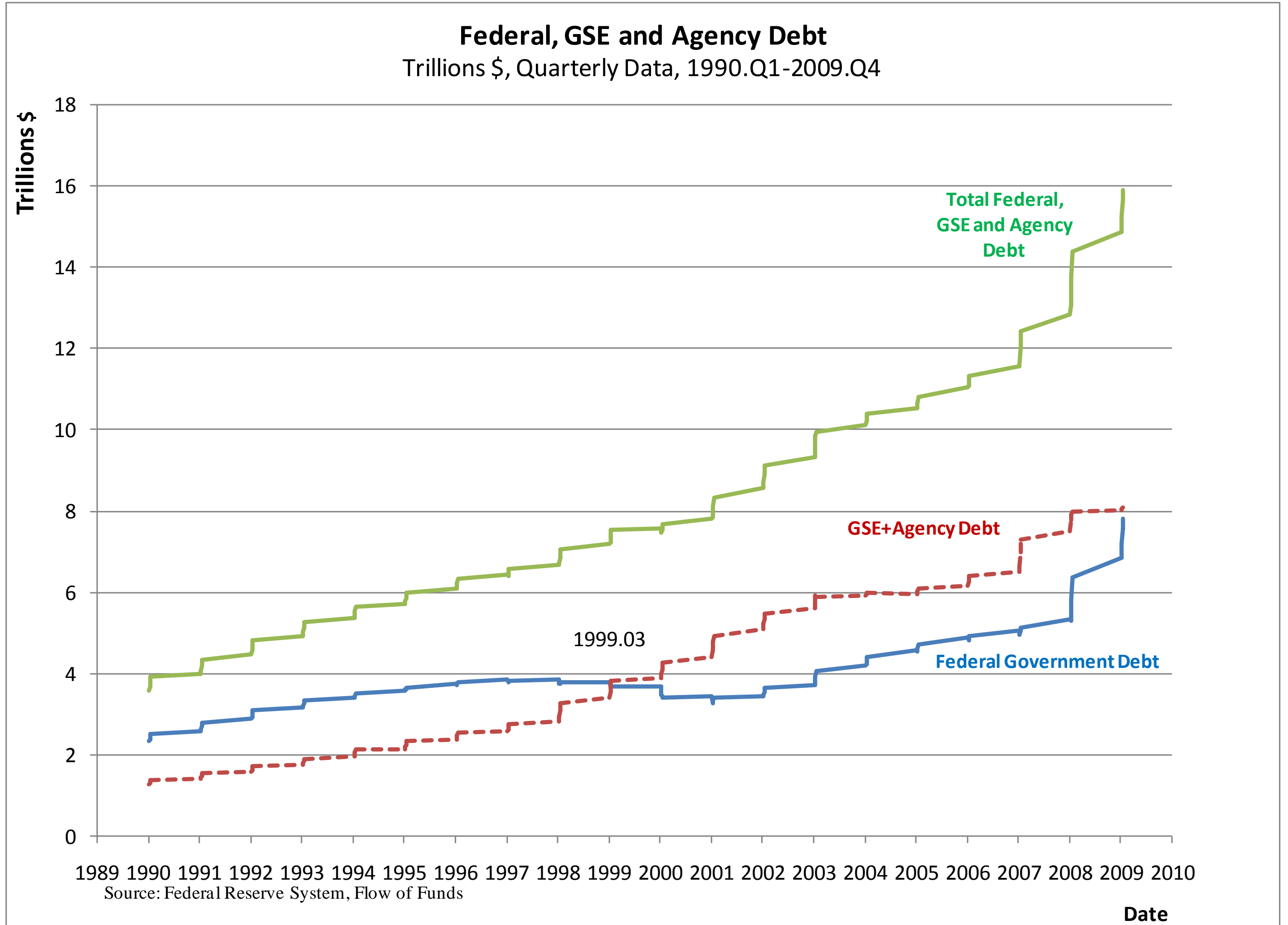

Figure 2

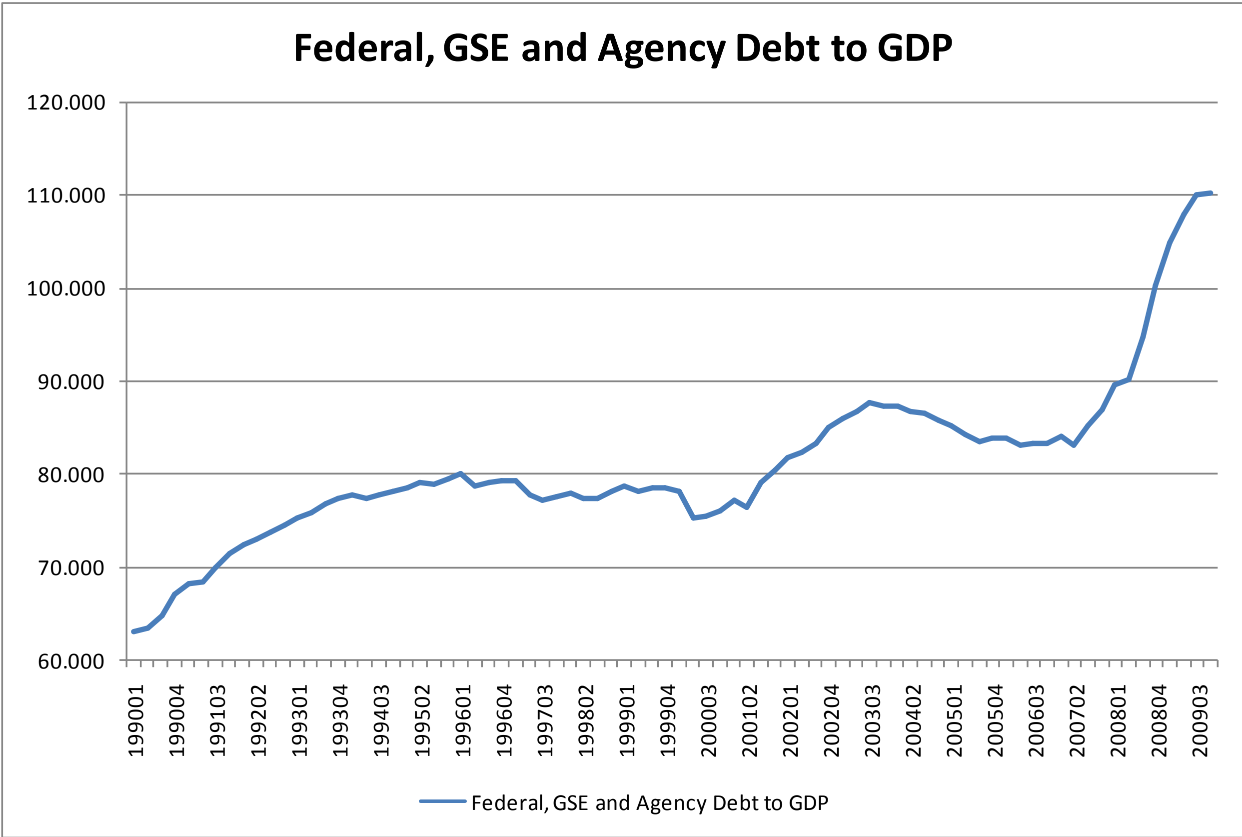

Figure 3

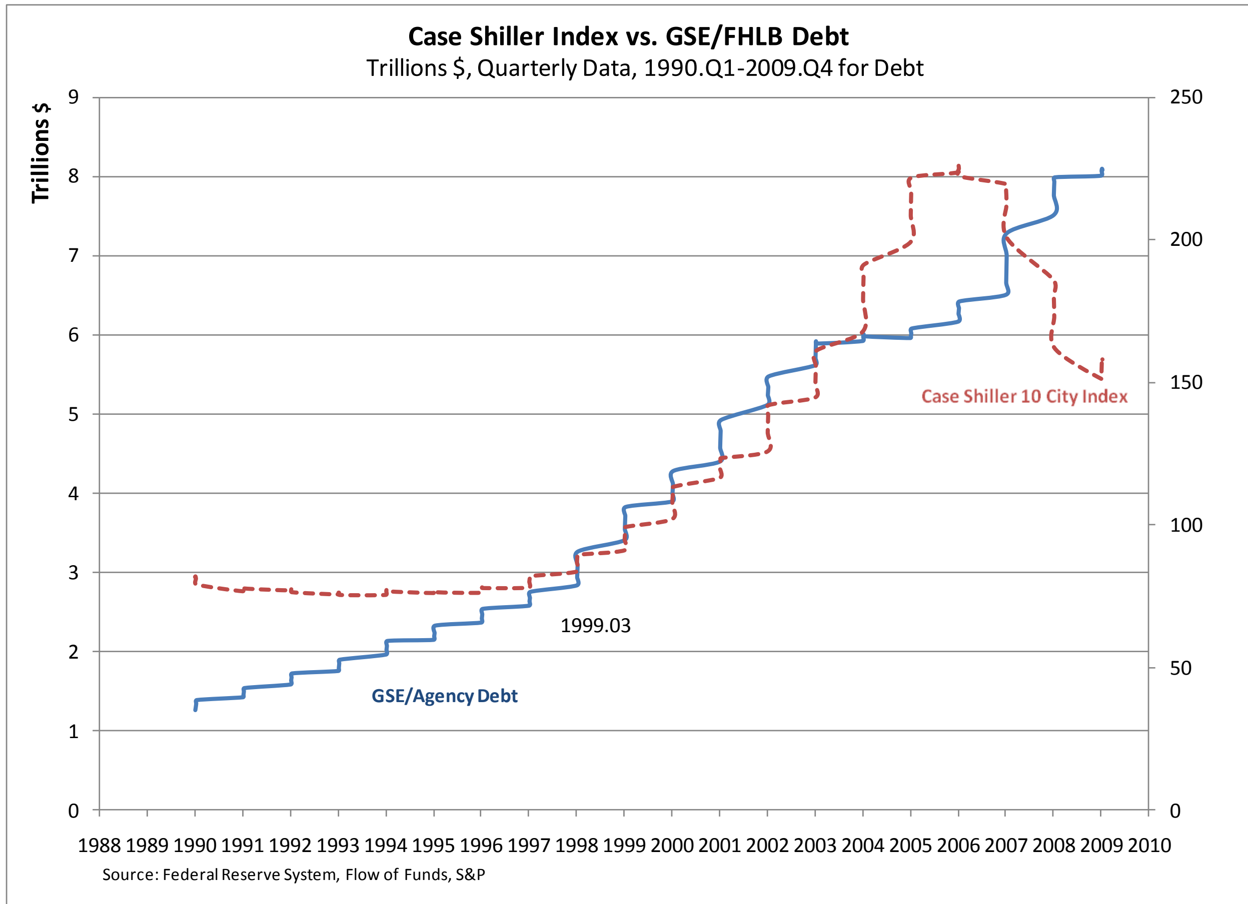

Figure 4