THE HOUSING DECLINE:
THE EXTENT OF THE PROBLEM AND POTENTIAL REMEDIES

TESTIMONY BEFORE THE U.S. SENATE
COMMITTEE ON FINANCE

BY

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Chairman Baucus, Ranking Member Grassley and Members of the Committee. I appreciate this opportunity to appear before you today. There is nothing more important that the Congress can do for the economy than to find measured and effective solutions to what has become a full-blown disruption in this nation's mortgage markets.

Mr. Chairman, I scarcely need to tell you about the role homeownership plays in this society. It embodies the American Dream and represents an invaluable economic asset for millions of families. A strong housing market has been a principal engine for our nation's economic growth, contributing to the development of stable and thriving communities, broadening the tax base, and rising employment opportunities.

Today's housing recession is serious, but far from devastating for our rather robust national economy. The subprime mortgage meltdown exists because there was an abundance of liquidity and soaring property values in many areas of the country, which allowed for exuberant lenders to provide ill-advised subprime loans, particularly Adjustable Rate Mortgages, which represent about 60% of foreclosures.

The impact of the subprime mortgage contraction is clear in certain areas; lending standards are tightening, subprime lenders are going out of business and the large investment banks are suffering significant losses after huge revenue increases resulting from the housing market. Most importantly, hard working Americans' homes are in jeopardy because the value of their home is less than their actual mortgage.

We face a difficult question: how can the government help homeowners without putting taxpayer dollars at risk, sending wrong signals to the housing market or over-regulating the industry?

Certainly we can't solve every homeowner's problems, but our immediate goal should be to meet proactively the legitimate needs of perhaps millions of American families who are at risk of losing their homes.

Quoting economist David Malpass of Bear Stearns, "Estimates of the recession risk have gotten overdone, in our view. In contrast with previous pre-recession periods, we note a proactive Fed, low real interest rates currently and in recent years, strong profits (they typically decline for multiple quarters prior to a recession), low jobless claims, strong equity performance, reservoirs of global liquidity, and strong foreign growth. We're maintaining our assessment of the recession risk at 20 percent)." I would add, it's my belief that the Federal Reserve should have been more aggressive in lowering interest rates by at least 50 basis points or more, rather than 25 basis points.

Another well-respected economist, Arthur Laffer recently said that “Over the last year and a half we have had a housing industry in the U.S. that has fallen off a cliff. Housing was one of the biggest contributors to GDP growth back in the 2005/2006 era and now is a huge, huge detractor from GDP. If you looked at it in isolation, you would say that that should lead to a downturn, or even a recession. This is what almost all the forecasters have been saying when they add up all the components of GDP, but that is not the right way to do it. When you look at the different sectors of the economy, you don’t just add up what happens in each sector, you look at the total interaction of all of the components of GDP. Housing construction has fallen, and that by itself should have led to a very sharp decline in not only GDP growth but also absolute GDP. But what has actually happened is that the trade deficit has declined substantially over this period, going from 6.2 percent of GDP to 4.8 percent of GDP. Trade has, in fact, added to GDP growth a little bit more than housing has reduced it. Therefore, total GDP growth has risen, not fallen, in spite of the fact that there has been a falloff in the housing industry. The loss of GDP in the housing sector will be made up for by gains in GDP in other sectors. The traded goods sector has done very well, more than offsetting the declines in GDP attributable to housing and finance.”

There is no need for the Federal government to be intrusive or overreact by changing basic economic policies. It just needs to be responsive to the real causes and effects of the subprime crisis. In my opinion, this means that our government must maintain a legal and regulatory structure that protects citizens and promotes fair business practices.

I am suggesting a three-pronged approach to this crisis that will be effective in dealing with the immediate effects of the current crisis and also help prevent a future recurrence. This approach requires the active involvement of several Congressional committees as well as Federal financial institution regulators.

First, Congress should provide mortgage tax relief so that people don’t get taxed on loan forgiveness. Under current law, if the value of a house declines and the bank forgives a portion of the mortgage, the tax code treats the amount forgiven as taxable income. Congress should reform the tax code to help homeowners refinance. H.R. 3648 that passed the House on a bipartisan basis is a good start and S. 1394 should be acted upon by the Senate without delay.

The Administration has also proposed allowing cities and States to issue tax-exempt mortgage bonds to refinance existing loans. Under current law, cities and States can issue tax-exempt bonds to finance new mortgages for first-time homebuyers, and this measure would give State housing finance authorities more flexibility to help troubled borrowers. Again, as long as this is also a temporary solution, I believe it merits support.

We should resist long-term tinkering with the tax code to address short-term problems. Our economy is fundamentally strong, and the U.S. government does not need to react with regulation or increase the tax burden on our nation. To the contrary, the Federal Reserve needs to continue to value a strong U.S. dollar and provide liquidity to our markets. Maintaining current tax policies will also allow our GDP to continue its solid growth, which will ensure that the pain of this housing decline doesn't spread throughout our economy, which will be the greatest tool in allowing our housing industries to regain their footing.

Second is a limited change to our bankruptcy laws to provide relief for distressed homeowners. Yesterday, important legislation passed the House Judiciary Committee to let bankruptcy judges give the same relief on home mortgages already available on commercial real estate loans, vacation home loans, car loans and other secured debt. This legislation doesn't cost taxpayers anything, and allows people who are able to make payments on the current market value of their homes to keep those homes. In the absence of this legislation, these homes will certainly be lost to foreclosure. It is estimated that over 600,000 homeowners will be able to use bankruptcy protection to modify mortgage loans and stay in their homes.

I hope the House will adopt H.R. 3609 - "The Emergency Homeownership and Mortgage Equity Protection Act of 2007" and the Senate will rapidly follow suit.

Third, there needs to be better scrutiny of lending practices and the rating agencies themselves. There is a consensus that the lack of effective oversight by the regulators of the primary and secondary mortgage markets contributed significantly to the problem we are now facing. Innovations in the mortgage industry can be good and useful. In fact, innovations by FHA, the secondary market and private sector lenders have been responsible for much of the unprecedented increase in the homeownership rate since World War II. At the same time, however, regulators can't be asleep at the switch and permit clearly unsound mortgage lending practices that place ordinary homebuyers at risk.

I applaud the White House and Treasury Secretary Paulson's efforts to encourage mortgage servicers to modify existing loans for a limited number of borrowers that cannot afford interest rate resets. However, depending solely upon the goodwill of an industry that bears no small measure of responsibility in this crisis is not the full answer. Moody's reported recently that servicers modified only 1 percent of mortgages that reset to higher rates this year.

Secretary Paulson and banking executives have also created a voluntary approach to freezing introductory rates; however the reality is that their proposal will help fewer than 5 percent of the people the proposal is trying to assist.

Voluntary actions after the damage has occurred are admirable, but hardly a substitute for ongoing, sound regulatory policies that make the mortgage lending industry more transparent, reliable and fair and protect homeowners from abusive or predatory lending practices.

Let me make a couple of comments about the Federal Housing Administration—FHA. For almost 60 years, FHA was the principal source of mortgage insurance that allowed millions of low- and moderate-income families to achieve the dream of homeownership. In recent years, an FHA in need of modernization has lost much of its market share to subprime mortgage providers whose lending guidelines have helped precipitate the current crisis. FHA must again become the principal responsible lending partner for those who need access to capital in order to own their home.

FHASecure, which the Administration has implemented, would expand the FHA's ability to offer refinancing by giving it the flexibility to work with homeowners who have good credit histories but cannot afford their current payments. FHA modernization would allow the FHA to insure bigger mortgages in high-cost states and expand FHA's authority to price insurance fairly with risk-based premiums. The House has passed FHA modernization legislation in each of the last two years. The Senate Banking Committee approved a modernization bill months ago but has been unable to move it to the floor.

In closing, Mr. Chairman let me restate that the most pressing need is to help the 2.2 million families who are in danger of losing their homes. Of course, we need sound policies that prevent the kinds of abuses and disruptions we are now experiencing. But to help current homeowners we need measured and appropriate responses that have an immediate effect, to protect our citizens and encourage sound business practices.

Why do we need to keep people in their homes? As HUD Secretary, I saw firsthand that homeownership makes our neighborhoods safer, encourages investment and raises families' overall standard of living. People care more deeply about their neighborhoods if they have an ownership stake. Minorities, especially, need to become homeowners in greater percentages if America is to truly democratize our free economic system. The subprime mortgage meltdown – and the practices of a few bad actors – should not obscure the great continuing benefits of homeownership.

Homeownership is not about left or right, conservative or liberal, Democrats or Republicans. For the past quarter-century, Republicans and Democrats have united around a conviction that owning a home is good not just for individuals and families, but also communities and for our country as a whole. Over the last 15 years, homeownership, especially among people of color, has risen to historic levels. In just the past five years alone, 2.8 million families achieved homeownership for the first time, and the ownership rate for minorities, while still far too low, surpassed 50 percent. I hope the government's response will focus on preserving the enormous gains we have made and protecting those for whom the Dream has yet to become reality.

Thank you, Mr. Chairman.