Testimony of Dean Baker
Before the Subcommittee on Housing and Community Opportunity of the House Financial Services Committee
March 19, 2009

Thank you, Chairwomen Waters for inviting me to testify before the subcommittee and to share my views on the foreclosure crisis and President Obama's Making Home Affordable Program.

I will begin by saying that I think that President Obama's program is a big step forward over prior proposals and will make it easier for millions of homeowners to stay in their homes. In particular, the plan to allow people without 20 percent equity in their homes to refinance mortgages with Fannie Mae and Freddie Mac will substantially reduce mortgage interest costs for up to 4 million homeowners as the President has indicated.

I believe the modification plan that President Obama has put forward is also the most realistic proposal that we've seen. The incentives for servicers to initiate modifications should prompt far more interest than we have seen in prior plans. The target of payments equal to 31 percent of income is also realistic, in that it should make mortgage payments affordable to many families who would otherwise be struggling.

In spite of the many positive aspects of the President's plan, I do still have reservations stemming from the fact that the President's plan does not appear to recognize the underlying cause of the current foreclosure crisis: the housing bubble which caused an explosion in house prices over the decade from 1996 to 2006. In the decade from 1996 to 2006, nationwide house prices rose by more than 70 percent after adjusting for inflation, creating more than $8 trillion in housing bubble wealth. In the century from 1895 to 1995, house prices had just tracked the overall rate of inflation.

It was inevitable that this housing bubble would burst with devastating effects for both homeowners and the economy. While inflation-adjusted house prices rose by more 70 percent nationally, in the markets most affected by the bubble (California, Florida, Nevada, and the East Coast from D.C. north) inflation-adjusted house prices rose by more than 100 percent. When the bubble burst, tens of millions of homeowners would be left underwater, with mortgages that far exceeded the value of their homes. The loss of wealth would also lead to a plunge in consumer spending as homeowners would have to adjust to the loss of an average of $110,000 in housing equity.

This situation was made worse by the lending practices of the financial industry during the bubble. The industry relaxed standards at exactly the time when it should have been tightening them and it persuaded millions of homeowners to take out adjustable rate mortgages that would reset to monthly payment levels that they could not afford.

It is important to note the centrality of the bubble in this story. Even the worst mortgage does not pose a serious problem in the context of rapidly rising house prices. A homeowner can always refinance or borrow against newly-created equity if house prices are rising at double-digit rates.

On the other hand, if falling house prices have pushed a homeowner underwater, these options do not exist.

Just as policymakers failed to recognize the bubble all through the decade when it was expanding, I am afraid that they still do not fully appreciate its implications, even as it is well on its way to deflating. As a result, plans such as the one that the President forward:

1) Do not help homeowners as much as they could;
2) Waste taxpayer money in many cases; and
3) Do not act to effectively stabilize the housing market.

The basic problem with the President's plan is that it does not distinguish between housing markets in which there either was not a bubble or the bubble has already deflated and the markets in which prices have a substantial amount left to fall. In the former set of markets, the President's plan is likely to be quite helpful, however this is not the case in the latter set of markets.

This point can be demonstrated by considering the price to rent ratio, which is the ratio of the selling price of a home to the annual rent that would be charged for renting a comparable unit. Historically, this ratio has averaged close to 15 to 1 nationwide, although there is some regional variation. At the peak of the bubble this ratio crossed 25 to 1 in many bubble markets, and it is still over 20 to 1 in some of these markets, even after prices have fallen substantially from their peak levels.

In a market where the price to rent ratio exceeds 20 to1, it is easy to show that families would be better off renting than owning even if they are able to get a low mortgage interest rate. To take a simple example, if the sale price on a house is $200,000 and the price to rent ratio is 20, then the annual rent on the same home would be $10,000.

By comparison, if a homeowner is able to get a 5 percent 30-year fixed rate mortgage (for simplicity, assume that the full price is borrowed) then they will pay approximately $12,800 on their mortgage. In addition, taxes, insurance, and maintenance are likely to add at least 2 percent to the annual cost of living in the home, or $4,000. This means that as a homeowner, this person will be paying $16,800 ($12,800 plus $4,000) each year for a home that they could rent for just $10,000.

The difference of $6,800 ($565 per month) is likely to be substantial a burden for most moderate or middle income families. It is effectively raising their housing costs by almost 70 percent compared to what they would pay as a renter. Of course in some bubble markets, where the price to rent ratios exceed 20 to 1, the "ownership tax" would be even larger.

The higher annual housing costs could perhaps be justified if there was reason to believe that homeowners would accumulate equity in their homes; however this is extremely unlikely in the deflating bubble markets. House prices are falling at more than a 20 percent annual rate in the Case-Shiller 20-City index. In some of the most bubble-infected markets, like Phoenix, San Diego, Los Angeles, and Miami, the rate of price decline is closer to 30 percent. By every measure, inventories of new homes, inventories of existing homes, and vacant ownership and rental units, there is an unprecedented excess supply of housing. As a result, it is almost inconceivable that house prices will stop deflating in these markets any time soon.

The implication is that the vast majority of homeowners in these deflating bubble markets, who today have little or no equity in their homes, will almost certainly have negative equity when they sell their home in a few years. (The median period of homeownership in the United States is approximately 7 years. It was less during the bubble years.)

It is difficult to see how we will have helped a family, if we craft a housing plan that encourages them to pay substantially more money in housing costs for several years than they would have paid to rent the same home, and then leave them facing a short sale a few years later when they sell their home. It was a serious failure of public policy that so many people were encouraged to buy into a bubble market, and we compound this failure if we don't carefully consider what would be best for families in designing proposals to address the housing crisis.

The failure to consider price to rent ratios also is likely to increase the costs for taxpayers. There is a much higher risk of future defaults, and much higher expected loss on each default, in the markets that are still inflated by the housing bubble than in markets in which prices have returned to their trend levels. When prices fall further in these bubble markets, homeowners who take part in this program will soon find themselves again underwater in their mortgage, or even further underwater.

The larger the gap between what is owed on a mortgage and the value of the home, the greater will be the incentive for the homeowner to default on their mortgage. If the current rate of price decline continues, a homeowner who has no equity today will be 20 percent underwater at this time next year, and 30 percent in some of the most inflated markets. In the example of the $200,000 home noted above, this translates into shortfalls of between $40,000 and $60,000.

When homeowners find themselves owing this much more than the value of their home, many will no longer struggle to meet monthly payments and simply turn the house back to the bank. This probability of course increases in the event of job loss, which unfortunately will be a likely occurrence over the next year. The result will be that taxpayers will incur substantial losses on these arrangements, even though there may have been little or no real benefit to homeowners. This will show up in the form of larger bailouts that Fannie and Freddie will need to request from Congress.

Finally, the failure to consider price to rent ratios will also undermine effort to stabilize house prices. It would be desirable to pursue policies that prevented the market from overshooting on the downside, with house prices falling below their trend level. It is unreasonable to believe that we could prop up house prices in areas where the bubble has not yet deflated (nor would it be desirable to do so even if we could). Nationwide, housing is almost a $20 trillion market. It would take enormous sums to try to sustain a nationwide bubble.

However, it is reasonable to believe that we could keep prices from falling further in the markets that do not have a bubble. A plan, like the President's proposal, can be effective in sustaining homeownership in these markets and should help to support house prices. It would be desirable to go even further and appropriate additional Neighborhood Stabilization Program funding for states, counties and cities to purchase and fix up foreclosed properties in targeted neighborhoods.

There is little risk that the government would lose substantial sums through investing in real estate in these markets since the sale prices in many cases are extremely low relative to current market rents. It would always be possible to rent out properties and receive incomes that are far greater than interest costs, until the housing market recovered.

The key point is that the government should focus on the price to rent ratio to determine whether it makes sense to commit additional taxpayer dollars to keep a person as a homeowner in their home. This will be best for both the homeowner and the taxpayer. It will also make it more likely that funds are actually committed to areas where they can help stabilize the housing market.

This policy may seem cruel to homeowners in the bubble markets, but the real cruelty was encouraging these people to buy into these markets in the first place. We do these homeowners no favors if we encourage them to incur excess housing costs for several years in the vain hope that they will one day accumulate equity in their home. We should know better than that and we should tell these homeowners the truth.

There is one simple and costless policy that Congress could pursue that would help homeowners in bubble-inflated markets. We can temporarily change the rules on foreclosure to allow homeowners facing foreclosure to remain in their homes as renters, paying the market rent, for a substantial period of time (e.g. 10 years).

This "right to rent" proposal would immediately give homeowners security in their home, so that if they liked the home, the schools, and the neighborhood, they would have the option to stay there for a substantial period of time.[1] This temporary change in foreclosure rules would also give lenders a strong incentive to renegotiate mortgage terms to allow homeowners to stay in their homes as owners, since few lenders will want to become landlords.

A great advantage of this proposal is that it requires no taxpayer dollars or bureaucracy (courts would need a list of appraisers who could determine market rents) and it could begin helping homeowners immediately after the legislation was approved. It also does not create any bonanzas that will be resented by those who do not benefit nor does it create any obvious opportunities for gaming. In short, this right to rent proposal gives people a break who have found themselves in a bad situation due to extraordinary circumstances. That is the most effective type of social policy.

[1] Baker, Dean (2008) "Subprime Borrowers Deserve an Own to Rent Transition," *The Economists' Voice*: Vol. 5 : Iss. 1, Article 5.