Testimony of Dean Baker

Before the Senate Committee on Banking, Housing and Urban Affairs
Turmoil in U.S. Credit Markets: Examining Proposals to Mitigate Foreclosures and Restore Liquidity to the Mortgage Markets
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Thank you, Chairman Dodd and Ranking Member Shelby, for inviting me to share my views on the mortgage crisis with the committee. My name is Dean Baker and I am the co-director of the Center for Economic and Policy Research. I am an economist, and have been writing about the housing bubble since 2002.

The current situation in the housing market is potentially the largest economic crisis in the post-World War II era both for the country as a whole, and the millions of homeowners facing the loss of their home. By its actions, Congress can help to either ameliorate some of its worst effects, or exacerbate the problems. For this reason, it is crucial that it consider carefully the implications of any legislation.

The Hope for Homeowners Act of 2008 is an ambitious effort to address the crisis created by the collapse of the housing bubble, and the epidemic of predatory subprime mortgages over the years 2003-2007. In assessing the merits of this proposal, it is important to realize that there are large differences in the state of the housing market across the nation. Policies that may be appropriate for some parts of the country may not be appropriate for other parts of the country.

In my comments, I argue that the mortgage guarantee program that is at the center of the Hope Act may be useful for parts of the country where housing prices are not abnormally high, but that this program is not well-suited for areas that still have bubble-inflated house prices.

Specifically, the program in bubble-inflated areas:

1) Will lead to situations in which homeowners spend far more on housing than renters would pay for comparable units;
2) Will lead to situations in which homeowners are unlikely to accumulate any equity at the point when they leave their home;
3) Will fail to stabilize prices.

I also argue the effort to stabilize prices in bubble-inflated areas is counter-productive. Insofar as it succeeds, it makes homeownership less affordable for young people and families moving into the area. I also briefly describe an alternative “own-to-rent” proposal that would guarantee moderate-income homeowners facing foreclosure the right to remain in their home as long-term tenants paying the fair market rent.

The Differential Impact of the Hope for Homeowners Act of 2008

It is important to recognize the large differences in the housing market that exist in various parts of the country. In the years from 1996 to 2006 the country experienced a housing bubble that had no precedent in the country's history. In the century prior to 1996, nationwide house prices increased at the same rate as inflation overall. In the decade from 1996 to 2006, house prices rose by more than 70 percent after adjusting for inflation. While there were real price increases almost everywhere, the areas that experienced the sharpest increase were concentrated on the coasts.

The housing market peaked in July of 2006. According to the Case-Shiller 20-city composite index, in the last year and a half house prices have fallen by 12.5 percent in nominal terms and are down by 16.5 percent in real terms from their peak. This price decline has brought prices in parts of the country back in line with their long-term trends.

In these areas there is no imbalance between house-sale prices and rents. For these areas, which include many cities hard hit by foreclosures like Atlanta, Cleveland and Detroit, the mortgage guarantee program in the Hope Act may be a useful mechanism for keeping homeowners in their homes and stabilizing prices. This is possible because prices are not out of line with the fundamentals in the housing market. In this context, the government can help to play a stabilizing role in the market as it did during the Depression with the Home Owners' Loan Corporation.

However, the situation is fundamentally different in the cities where the housing bubble was concentrated. In cities such as Los Angeles, San Diego, and Miami, house prices are still way out of line with fundamentals. In the cities with bubble-inflated housing markets, sale prices are still more than 20 times annual rents.[1] The loan guarantee program in the Hope Act is far less suited for these cities. (It would be easy to distinguish between these markets by not allowing a price guarantee to exceed a multiple of 15 times the appraised annual rent for a unit.)

At the most basic level, it is easy to show that families will almost certainly spend much more than necessary on housing costs in these cities, even if the program allows for a partial write-down of their current mortgage, and a new mortgage at a relatively low-interest fixed rate.

The arithmetic on this point is straightforward. Suppose that the interest rate on the new mortgage is 6.0 percent (it could, of course, be higher). For a 6 percent, 30-year fixed rate mortgage, the annual interest payments would be equal to 6.85 percent of the principle. Adding in 1 percent of the sale price for property taxes, and another 1 percent for

[1] For a comparison of ownership and rental costs in twenty major cities see Baker, Pelletiere, and Rho, 2008. "The Cost of Maintaining Ownership in the Current Crisis," Washington, D.C.: Center for Economic and Policy Research [http://www.cepr.net/index.php/publications/reports/the-cost-of-maintaining-ownership-in-the-current-crisis/].

maintenance and insurance together, brings total ownership costs to 8.85 percent of the sale price.

If the sale price-to-rent ratio is 20 to 1 (in many cities it is higher), then this house would rent for just 5 percent of the sale price. This means that owners would end up paying 77 percent more in housing costs than a family who rents a comparable unit. This is a large and unnecessary drain on the budget of moderate-income families, with an annual income in the range of $40,000 to $60,000. For a home that costs $200,000, this would imply additional annual housing expenses of $7,700 a year. These additional housing costs would presumably come at the expense of other necessary items such as health care and quality child care.

In addition, since house prices will continue to decline in these areas as the bubble deflates, it is unlikely that many of these families will accumulate any equity by the time they sell their home. In fact, most of the homeowners in these areas are likely to end up underwater, since house prices in the bubble areas could drop another 20-30 percent. In these cases, taxpayers will likely have to make up a portion of these losses due to the guarantees in the Hope Act.

It is unlikely that the Hope Act would be able to stop, or even substantially slow, the deflation of the housing bubble in these markets. The fundamental problem is that the supply of housing exceeds the demand at current prices. If prices did temporarily stabilize at bubble-inflated levels, it would only lead to more construction, which would then place further downward pressure on prices. A government house-price stabilization program that tries to maintain artificially high prices would face all the same drawbacks as farm price support programs that target artificially high prices, except the housing market is far larger.

Furthermore, it is difficult to see why it would be desirable to sustain artificially high prices, even if it were possible. Sustaining bubble-inflated prices means that it will be much harder for young people and families moving into an area to afford to buy a home. The people who get priced out of the market will then be forced to rent, or worse, will stretch their resources to buy a house at a bubble-inflated price, and thereby risk large capital losses.

In addition, the longer house prices take to deflate, the more people will make consumption decisions based on the assumption that the equity they have in their home is real. Much of the baby boom generation neglected to save over the last decade, in part because they thought they would have substantial equity in their homes when they reached retirement. Now that the oldest baby boomers are reaching retirement, they are finding that the equity they had been relying upon is not there. Delaying the deflation of the housing bubble will ensure that more people reach retirement without adequate resources.

In deciding on various proposals it is important to keep in mind that a loan guarantee program, such as the one laid out in the Hope Act, would require substantial fees associated with the issuance of new mortgages. At the very low end, the fees for issuing these mortgages would be 1.0 percent of the value of mortgages guaranteed. Since the process is fairly complex and creates a new financial instrument (the "soft second" mortgage), the fees could easily exceed 2 percent of the amount of loans guaranteed.

If the total value of the guarantees is $300 billion, then the commissions for issuing these mortgages will be between $3 billion and $6 billion. This is money that must come either from the taxpayers, or the homeowners, who are the intended beneficiaries. These fees do not necessarily over-ride the potential benefits of the program, but they should not be overlooked.

The Own-to-Rent Alternative – Providing Housing Security to Homeowners

A much simpler route, that could provide security to homeowners even in the most inflated markets, is to temporarily change the rules on foreclosure to allow homeowners the option to remain in their homes as renters paying the fair market rent. Under this proposal, a homeowner facing foreclosure could tell the judge, or court officer handling the foreclosure, that they would like to stay in their house as a renter.[2] The court would have an appraisal conducted to determine the market rent. The homeowner would then have the option to stay in the house as a renter, paying the market rent, for a substantial period (e.g., 10 years).

This policy would ensure that the homeowner is not left homeless. It also would keep the house occupied, and prevent the deterioration that typically afflicts the house and the neighborhood following a foreclosure. The policy could be carefully targeted both in time (e.g., it would only apply to mortgages issued prior to a certain date) and by home price (e.g., it would only apply to homes that sold for less than the median price in an area).

While providing a rental option, the "own-to-rent" plan is actually likely to lead to a situation in which many homeowners are able to stay in their homes as owners. Since most banks will not want to become landlords, this policy would provide lenders with a real incentive to negotiate terms that allow homeowners to stay in their homes as owners. In addition, it would require no tax dollars and no new bureaucracy.

Conclusion

There is no good way out of the crisis created by the collapse of the housing bubble. In the future, Congress and the Federal Reserve Board should act to ensure that we do not have such enormous bubbles in our housing market. However, good policy can alleviate much of the pain of the collapse, and that should be the focus of Congress at the moment.

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[2] This proposal is outlined in Baker, D. 2007b. "The Subprime Borrower Protection Plan," Washington, D.C.: Center for Economic and Policy Research [http://www.cepr.net/content/view/1274/45/].