13th Annual John T. Dunlop Lecture
Harvard University
Tuesday, October 2, 2012

America's Housing Policy: Charting a Course for Recovery

Thank you for your kind words of introduction. It is an honor and a privilege to be with you here this evening and it is a great pleasure to see so many good friends and colleagues.

I am delighted to come to Harvard, and I am especially pleased to be here tonight at the Joint Center, which for so many of us in the housing community is the gold standard for housing research and analysis. Thank you for your invitation.

I want to acknowledge Managing Director Eric Belsky and thank him and all the members of the Center's staff for the enormous contribution you make to the public's understanding of housing in America.

Let me also express my great appreciation and respect for Nic Retsinas. Nic is a national treasure, whose name is synonymous with leadership in housing. Harvard is truly fortunate to have someone of Nic's intellect and integrity as a member of its faculty.

I am especially honored to present remarks for the Dunlop Lecture series. John Dunlop left an important legacy of academic work blended with honorable service to our country with the enviable role of advising several US Presidents of both parties.
When I was nominated to serve as President Bush's Secretary of Housing and Urban Development, I told the Senate that my top priorities would be helping families find affordable and decent housing, and creating opportunities for homeownership, especially among minorities.

In many respects, the vision I had was one established decades ago by John Dunlop, whose advocacy on behalf of affordable, quality housing has left such a lasting mark. It is a privilege to have this opportunity to honor him this evening.

Owning a home is a fundamental aspiration for millions of Americans. For many, it's the most critical investment decision they make, and a milestone in life. Homeownership has enabled millions of families to build up equity over time, which has usually translated into greater household wealth and more financial security. This is what we call the American Dream.

Homeownership has certainly played a central role in my own personal journey. After my parents emigrated from Cuba and we were reunited here in the United States, I

remember the great pride they felt when they bought their first house with the help of an FHA-insured loan.
And it seems like yesterday when Kitty and I became homeowners for the first time.

Our home in Orlando was more than just a financial investment; it was the very platform from which we raised our children, built our family, and found our place as part of a larger community.

With the collapse of the housing market and the economic hardship that followed, many are understandably challenging fundamental assumptions and reassessing the value and role of homeownership in today's society. Have we overemphasized homeownership as a means to acquire wealth? When is homeownership appropriate for a family, and when is it not? Are we doing enough to support affordable rental housing? And are Federal resources properly allocated between supporting homeowners and renters?
These are just some of the questions on the minds of policymakers today, and we will continue to look to the Joint Center for expert guidance.

Current Market Conditions

No doubt, we are living through one of the most difficult economic periods in our nation's history. High unemployment, sluggish growth, and an unsustainable federal debt burden are problems that continue to challenge our nation's policymakers. And few would have predicted that, after six years of decline, the U.S. housing market would still be struggling to find its footing.

Yes, we have witnessed some hopeful signs of late, as sales of new and existing homes have increased and house prices are beginning to rise in some areas of the country. New multifamily construction is also on the upswing, after dropping to historic lows during the recession. But these positive developments cannot obscure some sobering facts: a staggering 11 million households today are underwater on their mortgages and more than 1.2 million families are somewhere in the foreclosure process. In many regions of the country, the large number of distressed properties will continue to dampen the housing market's prospects for the foreseeable future.

For minorities, the situation is particularly severe. Among African-Americans and Hispanics, homeownership levels have dropped dramatically in just three years. By 2010, the rate for black homeownership was 28 percentage points lower than the white homeownership rate, a wider gap than in 1990 or 2000. The rate among Hispanics has also dropped to pre-bubble levels, as more than 1.3 million Hispanic families have lost their homes.

In fact, the Center for Responsible Lending found that during the recent crisis, borrowers of color were more than twice as likely to lose their homes to foreclosure as white households.

There are a number of reasons for this disparity, but it's clear that practices like "reverse redlining" and steering minority families into risky mortgages and loans with high prepayment penalties were major factors leading to higher default rates within the Hispanic and African-American communities. What is so disheartening is that many of

those families who did default had good credit, a good income, and everything else required to qualify for a traditional long-term fixed-rate loan, but instead were steered into exotic, interest variable, costly mortgages they did not fully understand and could not afford.

In hindsight, it's obvious there were insufficient controls in place to prevent these pernicious practices from occurring. It also appears that stronger financial education or even mandatory homeownership counseling, at least for first-time homebuyers, may have helped people avoid these traps. Whatever our political views may be, I think we can all agree that this exploitation of the American Dream must never happen again.

Housing: Key to America's Economic Recovery

As much as housing contributed to our current economic difficulties, it can also help lead the way to a new era of prosperity.

A stable and strong housing market that avoids the mistakes of the past will directly translate into more jobs, higher family incomes, and a more vibrant economy.

Over the past several years, policymakers have paid far too little attention to this critical connection. It seems they have put housing in a wholly separate "policy bucket" divorced from other elements of national economic policy. In many respects, restoring our nation's housing market has been treated as an afterthought, rather than as a necessary precondition for economic recovery.

Once the smoke has settled from the November elections, it is my hope that Republicans and Democrats will join together and make housing a top national priority in full recognition of its intimate link to America's economic renewal.

There are four specific, but interrelated, areas of housing policy that I believe deserve immediate attention:

- Overcoming the scarcity of credit in today's mortgage market;
- Mitigating the impact of the foreclosure crisis;
- Establishing a clear vision for the future of our housing finance system; and
- Responding to the rising demand for rental housing.

Let me take a moment to share some thoughts on each of these issues.

Regulatory Uncertainty and the Scarcity of Mortgage Credit

Today, young families who avoided the storm, want to own a home, and are ready to take advantage of the lowest home prices and interest rates we've seen in quite some time, either cannot afford, or cannot qualify, under the new standards required to enter the mortgage marketplace.

If you think about it, in the span of less than 72 months, we went from one bad extreme to the other. It wasn't that long ago when a person could walk into a bank, provide no proof of income, little proof of assets, a couple pieces of identification, and walk out with a mortgage. Today, a credit-worthy couple can walk into a bank, bring a substantial down payment, provide enough paperwork for an FBI background check, and walk away with a "rejected" stamp on their mortgage application. It's no surprise that, in 2011, mortgage lending declined to its lowest level in sixteen years.

Sure, banks are not making the loans they traditionally made because they do not want to repeat past mistakes.

The bursting of the housing bubble hit their balance sheets hard, and many private financial institutions are naturally cautious in their approach to underwriting.

But it is also true that the uncertainty inspired by the *future* prospect of an array of new, potentially restrictive federal banking rules is having a profoundly negative impact on credit availability *today* and stalling the housing market's recovery. If these rules remain in their current form, as originally proposed, the effect on credit availability could be devastating.

Ironically, the source of many of these new rules is the Dodd-Frank legislation, whose aim is to protect consumers from the past failures of the mortgage market.

Much attention is rightly focused on the pending Qualified Mortgage, or "QM" rule. Dodd-Frank requires mortgage lenders to prove they have tested borrowers to show they actually have the "ability to repay" the loan by considering factors such as past credit history, income, employment status, and other financial resources. In theory, this approach is intended to ensure banks actually take a realistic and holistic look at borrowers, and that borrowers have a clear picture of the mortgages they are committing to.

On paper, the motivations behind QM make sense. But, as is the case with most federal regulations, it's the fine print that really counts.

Under the proposed rule, now under review by the newly created Consumer Financial Protection Bureau, a lender may presume that a loan has met the ability to repay test if it is a QM. So how a qualified mortgage, or QM, is defined becomes absolutely critical.

A definition that is too narrow will mean that most lenders will be cautious in their mortgage practices, lending to only the most credit-worthy borrowers, out of fear they will violate the ability–to-repay standard. The likely result will be that millions of otherwise qualified consumers will be shut out of the mortgage market altogether.

On the other hand, a sufficiently broad definition of QM – and one that provides some certainty that the ability-to-repay standard has been met -- will help ensure that mortgage credit flows to a more expansive group of borrowers since lenders will have greater assurance they are operating within the bounds of the law.

The concerns about the proposed QM rule are amplified by the battery of financial penalties, fees, and other damages the rule would impose on lenders who fail to meet

the ability-to-repay standard. A three-year statute of limitations during which defaulting borrowers can bring lawsuits is also a great concern, providing yet another reason for banks to hold back credit as they fear extended exposure to potential litigation.

Some experts even estimate it will cost a lender somewhere in the neighborhood of $70,000 to $100,000 to defend each ability-to-repay lawsuit brought against it. Is it any wonder, then, that those institutions less able to absorb these costs – small community and regional banks – are contemplating a complete exit from the mortgage business if the QM rule is drawn too narrowly?

The overriding imperative here is to strike the right balance: to protect consumers from abusive lending practices, while ensuring that mortgage credit continues to flow to those who need and want it and who can bear this financial obligation.

Unfortunately, there are other pending regulations that have similar market-damaging potential. The "qualified residential mortgage," or QRM rule, another product of Dodd-Frank, would require issuers of mortgage-backed securities to retain 5 percent of the risk on securitizations, unless the underlying loans qualify as QRM. The intention here is to ensure that those institutions pooling these mortgages have some "skin in the game" and don't infect the secondary market with high-risk loans.

Again, the motivations here are exemplary. And again, it's the details that cause great concern.

How does the proposed rule define a QRM? For purchases, it's a mortgage with a maximum loan-to-value ratio of 80 percent, meaning that only those mortgages with a 20 percent down payment can qualify for QRM status. For straight refinances, the loan-to-value ratio requirement is even tougher – 75 percent. Of course, these requirements are completely out of sync with the realities of today's market where most borrowers are unable to make a 20 percent down payment or have 25 percent equity in their homes. While these non-QRM borrowers might still be able to obtain a mortgage, they would do so at much higher interest rates.

Policymakers should also closely examine the possible consequences of other well-intentioned federal initiatives like HUD's proposed "disparate impact" rule under the Fair Housing Act. For example, if the CFPB embraces a narrow definition of QM, will banks that adopt more conservative lending practices in response find themselves subject to fair-housing litigation as result of underwriting policies that may have a "disparate impact" on minority groups?

In addition, we need a much clearer picture of how the more stringent capital requirements of Basel III will affect mortgage costs. Some observers suggest that the proposed increases in capital for home loans do not properly reflect actual risk and will, in fact, slow the recovery of the housing market.

To me, what is most troubling is the disconnect between idea and execution. Few in Washington have the full picture of how all these complex rules and requirements will *interact with each other*.

Nor do we have a good handle on what their *combined* impact may be on the willingness of banks, especially community banks, to extend mortgage credit. Yet such an

understanding is critical to reducing uncertainty and advancing policies that will spur the housing market's recovery.

So, I have a suggestion for our next President, whether it's Governor Romney or President Obama: After the Inauguration Day festivities have ended and you have had a chance to settle in, issue an executive order directing the Department of Treasury, in coordination with the various federal banking agencies, to inventory all these new rules and regulations. Direct the agencies to assess the likely impact of the rules on mortgage lending, with a focus on affordability and accessibility. Then, ask Treasury to report back to you within 60 days, not only with this assessment, but also with a concrete action plan to get mortgage credit flowing again.

Responding to the Foreclosure Crisis

Another area, of course, that continues to require the sustained attention of policymakers is the problem of foreclosed and distressed properties. Economists predict U.S. foreclosures will continue to mount, especially now that the banks and state attorneys general have settled many questions regarding foreclosure practices. With many of the questions about these practices now resolved, financial institutions will be pressed to clear their backlog of troubled properties.

Over the past few years, the Obama Administration has unleashed a number of foreclosure prevention and relief programs – HAMP, HARP I, HARP II, the FHA Streamline Refinance program, the HFA Hardest Hit Fund.

While all of these initiatives were well intended and some have produced positive results, all have fallen short of expectations, and of course none has completely solved the problem. So, recognizing there are no magic remedies or quick fixes, let me suggest a few ideas that might help some families.

Here's idea number one: Why not consider utilizing interest deferment as a way to improve the long-term performance of deeply underwater mortgages?

To help reduce the number of "strategic defaults" by borrowers who still have the financial wherewithal to continue making mortgage payments, Fannie and Freddie could offer an interest deferment when the mortgage far exceeds a home's value. Over a defined period of time – perhaps five years – the borrower would continue to pay the full amount due on the mortgage but the payment would be applied solely to reduce principal. In other words, any interest payments due would be temporarily deferred.

Fannie and Freddie would no doubt incur some costs, as they assume responsibility for making interest payments to their investors.

But, over the long-term, they may realize substantial benefits as borrowers continue to make timely payment on principal and fewer mortgages go into default. To ensure that borrowers bear some cost, the decision to defer interest should be linked to a commitment by the borrower to "share" with Fannie and Freddie (and, hence, the taxpayers) any appreciation in the home's value once it is sold.

My second suggestion seeks to protect local home values in neighborhoods hit hard by foreclosures. This is an increasingly important issue as the government looks to bulk sales of foreclosed properties as a means to clear local housing markets.

As you know, the act of foreclosure puts a big dent in a home's value and can dramatically reduce the price at which it can be sold. In fact, a recent MIT-Harvard study concludes that a foreclosure reduces the value of a house by some 27 percent.

Today, sales of foreclosed properties continue to be recorded as comparable home valuations – or "comps" -- in the appraisal of non-distressed properties located nearby. This practice depresses home values in the surrounding neighborhood and impacts the ability of potential homebuyers to secure adequate financing. To help remedy this problem, Fannie Mae, Freddie Mac, and the FHA could simply refuse to accept the sales of foreclosed homes as valid comps, forcing an upward reappraisal of the non-distressed homes.

In those markets where the volume of home sales is modest, thereby requiring the use of foreclosure sales as comps, an alternative approach might involve simply "bumping up" the sales value of a foreclosed home by an appropriate amount.

And, finally, why not encourage Fannie, Freddie, and FHA to adjust their underwriting standards for well-qualified self-employed individuals who are seeking to benefit from today's historically low interest rates through a refinance? As underwriting standards have grown increasingly tighter, many self-employed individuals are finding it difficult to meet the income-documentation criteria necessary to refinance.

People who work for themselves often receive compensation on an irregular basis from their customers and are unable to present a history of pay stubs to a potential mortgage lender as a way of documenting past income. While the total number of self-employed dropped during the recession, this group is still very large: Today, nearly 14.5 million Americans are self-employed working in either incorporated or unincorporated businesses.

Without increasing risk, Fannie, Freddie, and the FHA could make adjustments to their underwriting criteria that acknowledge the unique income-documentation challenges faced by the self-employed.

Each of these proposals can be implemented administratively without the need for Congressional action. Better yet, none requires the appropriation of any additional public funds.

Let me add that policymakers should be wary of "big splash" solutions like principal write-downs. In recent months, some in Congress have made a very public push for the Federal Housing Finance Agency to approve selective principal write-downs for underwater mortgages held by Fannie and Freddie.

Principal reduction paid for by the taxpayers is a bad idea on many levels. It's expensive, difficult to justify, creates an atmosphere of unfairness, and puts a chill on future mortgage contracts.

Those aren't just my arguments; that's what Secretary Geithner said to a Congressional oversight panel back in December 2009.

I give high praise to FHFA's acting-Director **Edward DeMarco** for standing firm on the question of principal reduction. He's taking a lot of heat for his decision, but he's right.

A Vision for a Future Housing Finance System

Over the longer term, our country must redesign and rebuild its broken system of housing finance.

In many respects, this system functions as the "motherboard" for all housing in the United States, linking secondary-market investors in places like London and Tokyo to homeowners in Lincoln, Nebraska, and Tallahassee, Florida, through a complex circuitry of mortgage originators, servicers, securitizers, and guarantors. It can be a powerful machine that produces wonderful benefits.

Before we look to the future of housing finance, we should reflect on what lessons we can draw from the past. Here are a few of my conclusions:

First, if it seems too good to be true, it probably is. At the height of the housing boom, many borrowers and lenders convinced themselves that home prices were heading in one direction, and one direction only – up. Many borrowers, of course, took on mortgages they could not hope to service over the long term with the expectation that they could accumulate home equity and then refinance into a more affordable loan. This worked out for a while, but then the laws of gravity took over and house prices began their downward slide.

We can't make this mistake again. Any future system of housing finance must be resilient enough to weather the inevitable periods when the market takes a drop, even a big drop.

Second, prudent underwriting is absolutely critical. In fact, it's the foundation for a sound system of housing finance. I'm still a big believer in the power of homeownership to help lift families into the middle class, but during the height of the housing boom, many lenders abandoned prudent underwriting under the guise of promoting homeownership. And, yes, in some instances, federal housing policy encouraged this practice.

Finally, protecting the interests of the taxpayers must always be paramount. The taxpayers have paid dearly for the government's conservatorship of Fannie and Freddie – some $150 billion to date with little chance for recovery.

Business models in which gains are "privatized" and risks "socialized" do not work.

The BPC Housing Commission

I have the good fortune of serving on the Housing Commission of the Bipartisan Policy Center where we are endeavoring to develop a vision for a new system of housing finance. The Commission was launched late last year with the generous financial support of the MacArthur Foundation. Former HUD Secretary Henry Cisneros, and former Senators George Mitchell and Kit Bond, have joined me as co-chairs of the

Commission, which has 21 members from both political parties who bring to the table a wide variety of experiences.

Although the Commission has not issued its final report, and our deliberations continue, there appears to be broad agreement on some fundamental issues.

Like other observers, the Commission believes the federal government is playing *far too large a role* in our nation's housing finance system. Yes, greater federal intervention in the housing market was necessary when the market began to collapse, but the dominant position held by the federal government today is unsustainable. Figuring out how best to encourage private capital to assume a greater share of the credit risk in housing finance is a continuing focus of our work.

Consider these facts: In 2010, purely private-sector mortgage originations constituted only 12 percent of all originations, compared with 53 percent ten years earlier in 2000. Loans guaranteed by FHA and the Department of Veterans Affairs, combined with Fannie and Freddie conforming loans, were a staggering 88 percent of all originations in 2010. In 2011, securities backed by Fannie, Freddie and Ginnie Mae constituted 97 percent of the mortgage-backed securities market, with non-agency funds less than 3 percent. In other words, the private-label MBS market has virtually gone the way of the dinosaur – it's extinct.

So getting private capital off the sidelines and back into the game is imperative. The direction we must take is clear: Fannie and Freddie should unwind in an orderly fashion and we must establish the conditions to allow the private sector to step in and fill the gap as the government footprint becomes smaller.

Transitioning to this new, less government-centered, system will take time. The housing market remains very fragile and precipitous actions could easily push the market into a state of further disarray.

But, in the short term, there are steps we can take to help move us toward the goal of greater private-sector involvement.

Congress, for example, should lower the loan limits for Fannie, Freddie, and FHA to allow larger loans to flow to the private sector. As it has started to do, the FHFA should also gradually increase the guarantee fees that Fannie and Freddie charge lenders, moving the government pricing structure closer to the level one might expect if mortgage credit risk were borne solely by private capital. And FHFA should continue shrinking the size of the Fannie and Freddie investment portfolios.

While the Commission envisions a much more limited federal role in housing finance, it does see FHA, VA, and Ginnie Mae as vital sources of liquidity for lower- to moderate-income borrowers and first-time homebuyers.

We also recognize that some level of government intervention is necessary to ensure a continued supply of mortgage credit to the "middle of the market" currently served by Fannie and Freddie. The key is to structure the government's role in a way that narrowly circumscribes taxpayer risk, while promoting stability and affordability. So any guarantees that are offered by the government should be explicit, appropriately priced to cover catastrophic declines in the housing market, and triggered only after private capital

has assumed the “predominant” share of any loss. The government, in other words, should function solely as the insurance backstop of last resort.

It’s been more than four years since the federal government first nationalized Fannie and Freddie, and yet Washington still has no clear plan for the future of housing finance. Next year, Democrats and Republicans must begin to bridge their differences, find common ground, and make housing finance reform the kind of top national priority it deserves to be. And, yes, it’s my hope Congress and the Administration will find the Commission’s final recommendations of some value as they engage on this vital issue.

The Increasing Importance of Multifamily Rental Housing

As we redesign our housing finance system, we must not forget the multifamily side of the ledger. In fact, multifamily may be the headline story of this decade. There are a number of factors that are now converging to put enormous pressure on multifamily demand.

The first factor is obvious: The homeownership rate has declined by nearly four percentage points since it peaked in 2004. Today’s homeownership rate of 65.5 percent is near a fifteen-year low.

Assuming that a significant number of today’s distressed borrowers will default on their mortgages, we can assume that today’s homeownership rate will drop even further, meaning that more and more families will look to multifamily as a housing alternative.

Demographic factors are also at play. As the Joint Center has amply shown, the Echo Boomers – those 62 million young Americans born between 1981 and 1995 – are now beginning to strike out on their own. As they establish their own households for the first time, many will seek rental housing, often in urban areas where the supply of affordable rentals is limited. The numbers here are huge: five to six million potential new renters.

Our society is also becoming more ethnically and racially diverse. Hispanics are expected to make up an increasing share of the population – more than 25 percent of total population by mid-century. While homeownership is an important aspiration for many minority families, some will simply not have the resources to make homeownership work, particularly as underwriting standards become more stringent.

All these factors are already being felt in many large metropolitan areas, as vacancy rates are dropping and rents are increasing.

As I see it, the key question here is whether the private market will respond to the increased demand in these large metro areas with a sufficient number of new units. Otherwise, rental costs will be even more unaffordable for large numbers of households. New multifamily construction is cranking up, so the market senses an opportunity. But will it be enough?

Policymakers should consider whether there are ways to better leverage private-sector resources though improvements to valuable programs like the Low-Income Housing Tax Credit. With more than 100,000 units of multifamily stock being lost each year to obsolescence, we should also assess whether our existing tax policies sufficiently

support the *preservation* of existing units. And let's not forget the impact that local regulatory policies can have on rental supply and affordability.

Above all else, we need to have strong housing finance system that helps meet the capital needs of the multifamily sector.

In states like Florida, Arizona, and Nevada, where the foreclosure crisis hit the hardest, multifamily can be what I like to call the "Sunbelt Solution" to many of our immediate and longer-term housing needs. This is particularly true for smaller multifamily properties, those with 20 units or less, that can serve as an affordable housing option for families facing difficult economic circumstances. Many of these properties are owned by individual investors who hold them for retirement income, long-term capital gains, or to pass on to their children. These same investors often personally manage the properties.

As Eric and the Joint Center have documented, the small multifamily segment of the market faces unique financing challenges. The lack of good information to perform underwriting and the expense of due diligence; the lack of economies of scale in loan origination, servicing and securitization; and lower turnover rates that make it harder to establish resale values – these are just some of the challenges. The current finance system has not served this segment of the market well. In fact, the system has largely ignored small multifamily. So, as we think about the future, we have an opportunity to develop some innovative approaches to expand access to capital for this increasingly important market segment.

Conclusion

The challenges in housing today are so numerous and difficult that it may seem overwhelming. In fact, I think much of Washington's *inaction* on housing stems from the very complexity of the problems themselves. It's quite natural to convince ourselves that we should put these problems off to another day when the timing might be better, the conditions better suited for change. Of course, these days often never come.

Although those of us here may disagree on some of the specific policies we should pursue, we all agree – I believe -- that housing is just too important to put off to another day.

For the millions of families struggling to stay in their homes…for the millions of young adults who cannot get a mortgage or find affordable rental housing…for our nation's economy whose growth depends so much on a vibrant and stable housing sector…next year must be the year that housing returns to prominence on the national policy stage.

Thank you for your kind attention this evening.

-END-