FedFin Client Report

Wednesday, September 13, 2006

Senate Banking Concerned About Condition of Housing Market

Report: **MORTGAGE12**

Executive Summary

Two Senate Banking Subcommittees met today to explore the state of the U.S. housing market in a hearing that laid the groundwork for next week's examination of nontraditional mortgages and offered further insight into GSE-reform legislation (see FSM Report **GSE89**). Senators were unanimously concerned with how the softening of the housing market would affect the broader economy, with specific worries on the proliferation of nontraditional mortgages. The economists testifying did not anticipate large economic problems, although they noted that there could soon be strains on borrowers with nontraditional mortgages. However, they felt these products are not enough widespread to threaten the broader economy. When asked by Sen. Carper (D-DE) to provide thoughts on a portfolio limit in GSE-reform legislation, the economists cautioned about the impact of overly restrictive limits. OFHEO's chief economist said that the Senate bill's portfolio language could bar the GSEs from holding certain affordable-housing loans, although he was in favor of the new regulator receiving Congressional direction on the limit. Sen. Sarbanes (D-MD) was very concerned about doing something to disrupt the fragility of the housing market, saying he was happy to create a safety and soundness regulator but that anything more could cause problems. The Senate Banking Committee will hold a hearing next week focusing specifically on nontraditional mortgage products. The following client report analyzes today's hearing.

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Analysis

Opening Statements

Sen. Allard (R-CO) was concerned about the state of the housing market and wanted to know how the projected downturn in housing would effect individuals and manifest itself in the broader economy.

Sen. Schumer (D-NY) was concerned about the role of nontraditional mortgage products in creating the housing bubble.

Sen. Bunning (R-KY) criticized the Federal Reserve, and specifically former Fed Chairman Greenspan, for keeping interest rates low in the early part of the decade and accused the Fed of fueling the housing bubble.

Testimony

OFHEO Chief Economist Patrick Lawler said that housing-price gains in recent years were due to historically low interest rates and the proliferation of nontraditional mortgage products. He also noted that, in each of the last two years, subprime lending has accounted for more than 20% of the market. In the long term, Mr. Lawler thought housing markets will continue to perform well, especially if immigration continues. He did, however, note that housing markets could significantly soften if there were a GSE disruption, which OFHEO is working hard to avoid.

FDIC Chief Economist Richard Brown said that the banking industry is exhibiting extremely low credit losses and has historically high capital. Given the FDIC's study of historical housing booms and busts, Mr. Brown suggested there may soon be housing-price stagnation, but that a widespread bust is not likely. He also highlighted the link between housing busts and the performance of local economies, offering that history may not be as good a predictor for what will happen given the prevalence of nontraditional mortgages.

NAHB Chief Economist David Seiders said that, while there will be adverse secondary effects as a result of the housing slowdown, such as the negative impact on consumer spending and payment shock for individuals with nontraditional mortgages, the size and timing of these effects will not threaten economic expansion. He also noted the difficulty in predicting the full effect of payment resets on nontraditional mortgages and the true size of the inventory of homes for sale.

NAR President Tom Stevens said that there is not a national housing bubble because all housing is local. He said that the two largest reasons for the housing slow down are the increase in interest rates and the insufficient presence of the GSEs and FHA in high-priced markets. He also noted that the lack of property

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insurance has hurt housing in certain areas of the country.

Q&A

Sen. Allard asked how the current housing boom differs from previous ones and what impact the rising cost of raw materials has had on housing prices. Mr. Brown said that commodity prices have had some impact on housing prices. He then said that the current housing situation is different from the past because of the vastly different structure of mortgage lending, but also noted that there are enough similarities between the past and the present to suggest the outcome will not be drastically different. Mr. Seiders said that the explosion of house prices was primarily demand driven and was exacerbated by supply constraints, in large part due to local rules that stifle building.

Sen. Reed (D-RI) asked whether foreclosure rates will increase and how that would affect the economy. Mr. Seiders said that, if there is an increase in foreclosures, it will be manageable. He added that one potentially significant problem is the failure to understand from data the layering of risks in mortgages, such as with simultaneous seconds.

Sen. Bunning asked about the impact of the Fed's decision to keep rates low in previous years. Mr. Lawler said that low rates likely led to an increase in ARMs, stimulated development of affordability products and shaped the psychology of investors. Mr. Brown added that foreign investment in Treasury's and mortgage instruments helped keep long-term rates lower than expected.

Sen. Carper asked if the housing bubble was driven by investor flight from equities. Mr. Lawler said that this was a contributing factor. Mr. Stevens added that wealth accumulation was another factor, noting that the market for second homes is still strong.

Sen. Carper asked witnesses for guidance on GSE reform and portfolio limits. Mr. Stevens suggested leaving powers over the portfolio to the regulator and not creating an artificial cap. Mr. Seiders said he was worried about the impact the restriction would have on the spread between the ten-year Treasury and mortgage rates, adding that a "draconian" cap would affect the spread. Mr. Lawler said that Congress should give guidance on the portfolio limit, but that the Senate bill's portfolio language could be interpreted in a way that could hurt the GSEs' ability to function in a crisis or buy affordable-housing loans.

Sen. Sarbanes highlighted a statistic in the FDIC testimony that 45% of first-time homebuyers received 100% financing and asked whether this was concentrated in boom areas. Mr. Brown said that he did not know about the concentration, but that this statistic includes situations in which a simultaneous second has taken the place of mortgage insurance. He said that these products had helped maintain demand in the later stages of the boom. Sen. Sarbanes then asked

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what the impact would be on these homeowners if prices decreased. Mr. Brown said that, while some homeowners could be in trouble, some urban homeowners have high incomes and would be less sensitive to downturns. Mr. Stevens said that new mortgage products have been phenomenal for getting people into homes, but that it is important to make sure that the borrower can afford the product they purchase.

Sen. Sarbanes then described the housing market as a fragile system that could be disrupted at this point in time by two factors, an increase in interest rates and GSE reform. Regarding the latter, he said that both parties would like to create a strong regulator with bank-like powers, but that he is concerned that giving the regulator something more than safety and soundness powers could disrupt the housing-finance system. He also noted that people with interest in the low-income housing tax credit, mortgage bonds, and multi-family housing have told him the Senate bill's portfolio restrictions could put them out of business. Mr. Lawler later noted that only 30% of GSE assets are for meeting their affordable housing goals and said Congress should give direction to the regulator about which assets are most important and help affordable housing.

Sen. Sarbanes asked whether the Fed has been receptive to NAR and NAHB economic analyses. Mr. Seiders said he routinely meets with the Fed in Washington and sometimes brings larger homebuilder CEOs in to meet with the Fed, but that there is not much contact with the regional Fed presidents. Mr. Stevens said that the Fed has been open to meeting with him. Sen. Sarbanes suggested the groups meet with regional Fed presidents.

Sen. Reed asked the witnesses whether they felt they adequately understand the nontraditional-mortgage marketplace. Mr. Brown said that the FDIC receives cutting edge statistics from such companies as LoanPerformance. Responding to a follow up question, Mr. Brown said that about 10% of the U.S. mortgage book is made up of nontraditional mortgages from 2004 and 2005, so that, even if there are problems, it won't hurt the broader economy. He also noted that, while there will likely be a period of credit distress ahead, many of these loans were securitized, so the risk had been efficiently spread. Mr. Brown said that some individuals would be negatively impacted. Mr. Seiders added that many of these loans don't have significant pre-payment penalties, so the industry may soon see a miniature refinancing boom.

HJK

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