Thank you, Chairman Johnson and ranking member Shelby, for inviting me to testify at the hearing today on the future of the housing finance system.

My testimony can be summed up in three words.

Just Say No.

The time has come to say no to the mortgage lobby. Send them home empty-handed. Let ordinary Americans win one for a change.

A coalition of real estate agents, Wall Street investment firms, mortgage bankers, community activist groups, and others spent the last 40 years lobbying to protect and expand subsidies for mortgage credit. They usually got what they wanted. And what did the American public get? We got a housing bubble, a financial crisis, a bailout, a recession, and millions of homeowners drowning in debt.

That shameless coalition is back again, insisting that government must provide a guarantee in the mortgage market. Just say no.

This country is in a mess today because mortgage borrowing and mortgage lending were carried to excess. Given what we have just experienced, one would think that proposing a new government guarantee to prop up the mortgage industry would be considered totally inappropriate. If a mob of people had gone through the town on a drunken rampage, committing reckless acts of vandalism, would the city officials be focused on trying to restock the bars?

There is a way to guarantee reliability of mortgages that does not require a government agency. The solution is for most borrowers to make down payments of 20 percent, which was typical before the madness of the last two decades. Stop making so many loans where the down payment is just 2 percent (or less). At the risk of oversimplifying slightly, I would say that a loan with a 20 percent down payment is a good loan, and a loan with a 2 percent down payment is a bad loan. With good loans, the mortgage market does not need a government guarantee. With bad loans, a guarantee can only come to grief.

What should we say to someone who wants to buy a $200,000 house but has only $5,000 saved up? In most cases, we should say the same thing we would say if they wanted $200,000 in poker chips in Las Vegas or $200,000 worth of stock. We should just say no.

If it is in the public interest for more people to own their homes, then I would suggest coming up with policies that expand home ownership, rather than mortgage indebtedness. We should try to come up with
programs that encourage people to save for down payments, rather than encouraging them to take on too much debt. Instead of trying to ensure that everyone has access to the mortgage equivalent of cheap alcohol, we should be helping people to drink less.

Does the government need to support the rental market? Then provide more generous housing vouchers to renters, rather than handing out subsidies that encourage indebtedness among landlords. Landlords, too, should have significant equity in their properties. Otherwise, at the first sign of trouble they will stop maintaining their buildings, allowing them to fall into disrepair and adversely impacting their tenants.

These days, it seems as if everyone in Washington has a blueprint for restructuring the mortgage industry around some newly created institution or government guarantee program. Just say no.

This is the time of year when college basketball is on everyone’s mind. Imagine what would happen if during a game, a team were to go through a streak of terrible shot selection, falling way behind and leading the coach to call time out. A normal coach would say, “Settle down. Take the shots you know how to make, and stay away from low-percentage shots.” If instead he were a Washington policy wonk, he would say, “We need to restructure the whole team. No more two guards, two forwards, and a center. From now on we are going to use a bishop, three pawns, and a rook. Refer to the diagrams in this memo.”

The mortgage industry equivalent of bad shot selection is bad loans. If the mortgage industry stops making bad loans, then Washington does not need to come in with a new playbook and a new set of roles that people have to learn to play. With good loans, the mortgage finance business will take care of itself.

The most urgent need for housing finance policy today is to ration the use of government-subsidized mortgage credit, which right now is excessive and out of control. I hope that as soon as tomorrow, Congress will enact legislation that narrows government support to the single purpose of helping people purchase homes for their own use. Such legislation would prohibit Freddie Mac, Fannie Mae, and FHA from offering any support for loans to non-owner-occupied home borrowers, for cash-out refinance mortgages, for non-amortizing loan products, and for any other mortgage that fails to fulfill the purpose of helping households build up equity in their places of residence.

These immediate steps should be followed by legislation that reduces the maximum loan amount eligible for purchase by, say, 25 percent each year. Loan limits for the agencies will permit private lenders to re-enter the market. Once we create a playing field in which private lenders have a chance to compete, we can reassess the need for further government intervention. My prediction is that we will find that the private sector is fully capable of taking care of the mortgage needs of real home buyers. But in any event, we do not have to make that determination until we give the market a chance.

As we reduce the role of government agencies, we can monitor the behavior of the private sector and adapt our policies accordingly. If the private sector goes back to making bad loans, which I doubt will happen, we can regulate to stop that. If the private sector leaves gaps in accessibility to good housing, we can enact programs to address that. Those programs might consist of assistance targeted at specific needs, rather than generic subsidies to the mortgage industry.

I understand why various interest groups want to have a government guarantee for mortgages. Without a guarantee, it is possible that the secondary mortgage market will decline in importance or perhaps even disappear altogether. We might see the market revert to old-fashioned mortgage lending, where the bank keeps your loan until you finish paying it off.¹ I think that home owners could live with that. I understand

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that it would be hard on the mortgage bankers, the Wall Street firms, the rating agencies, and the other special interests that count on the government to prop up the secondary market.

Just say no.
Appendix: Charging for Risk

Some proposals for a government guarantee envision charging a fee to private institutions that take advantage of the guarantee. This is much easier to do than it sounds.

If the same fee were charged, regardless of mortgage characteristics, it would make the institutions that use the guarantee relatively less competitive in the market for low-risk loans and relatively more competitive in the market for high-risk loans. Thus, charging for the guarantee could very well have the perverse effect of encouraging institutions to take more risk.

In theory, the solution is for the government to charge a variable guarantee fee, one which is higher for loans with riskier characteristics. The agency administering the fee would develop “risk buckets” and charge different fees for loans in different buckets.

However, even risk buckets can be manipulated in what is known as “regulatory arbitrage.” Many of the fancy new financial vehicles created in the decade leading up to the financial crisis were introduced in order to get high-risk assets reclassified into low-risk buckets. See my paper, Not What They Had in Mind: A History of Policies thatProduced the Financial Crisis.²

² Arnold Kling, Not What They Had in Mind: A History of Policies that Produced the Financial Crisis of 2008 (Arlington, VA: Mercatus Center at George Mason University, 2009),