S. HRG. 109–1085

THE HOUSING BUBBLE AND ITS IMPLICATIONS FOR THE ECONOMY

HEARING

BEFORE THE

SUBCOMMITTEE ON HOUSING AND TRANSPORTATION

AND THE

SUBCOMMITTEE ON ECONOMIC POLICY

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON

THE ISSUES SURROUNDING A HOUSING BUBBLE AND ITS POSSIBLE IMPLICATIONS FOR THE ECONOMY

WEDNESDAY, SEPTEMBER 13, 2006

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE
50–302 WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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WEDNESDAY, SEPTEMBER 13, 2006

WITNESSES

Additional Material Supplied for the Record

*PowerPoint Presentation on *Current and Future Real Estate Trends* is retained in Committee files.

HEARING ON THE HOUSING BUBBLE AND ITS IMPLICATIONS FOR THE ECONOMY

WEDNESDAY, SEPTEMBER 13, 2006

U.S. SENATE,
SUBCOMMITTEE ON HOUSING AND TRANSPORTATION
SUBCOMMITTEE ON ECONOMIC POLICY
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
Washington, DC.

The Subcommittees met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Wayne Allard, and the Hon. Jim Bunning, Chairmen of the Subcommittees, presiding.

OPENING STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. The Committee will come to order.

Both Senator Bunning and myself like to start on time and we like to follow the rules of debate, so I would like to have you watch your time clocks. We have one here and then one on the table, and then we will proceed.

I am pleased to convene a joint hearing of the Housing and Transportation Subcommittee and the Economic Policy Subcommittee. I have always enjoyed opportunities to work with my friend Senator Bunning.

The possible housing slowdown has significant implications for both the housing markets and for the economy as a whole, so this topic is of great interest to both subcommittees. During recent years the country has seen dramatic escalations in home values. While this has been very beneficial for homeowners, it has definitely created challenges for home buyers.

Over the last 5 years, home prices have increased nationwide by 56 percent. The inflation-adjusted increases are higher than at any point in 26 years since data has been tracked. The story is even more startling in selected markets. For example, home prices here in the District of Columbia have increased by a whopping 120 percent over the same 5 years.

Part of the price run-up has been fueled by low interest rates, favorable tax treatment, and changes in the credit markets. However, there are questions as to whether fundamentals can fully explain the increases, particularly over the last several years as interest rates have risen. More recently we have seen signs that the market is cooling. Existing home sales are down 11.2 percent. On a year over year basis in July, new home sales fell 21.6 percent. Last year the Office of Federal Housing Enterprise Oversight, called OFHEO, also reported the largest housing price deceleration in three decades.

We have gone through a period of housing expansion, in part because of the efforts of Congress to expand home ownership opportunities. Will there be a significant reduction in the rate of expansion is a question that would ask, and what are the implications of this possibility, is a follow-up question.

While housing has received attention, the discussion has always been as a side issue at other hearings, such as the semiannual monetary policy hearing. However, these interactions have only offered a brief glimpse into a very complicated topic. Today's hearing is intended to offer members an opportunity to examine this issue in depth.

Specifically, we are interested in learning more about the current state of the housing market, the degree to which, if any, the housing bubble might exist, key factors that contributed to the current status, projections for where the housing market will be in the short, intermediate, and long-terms, how these projections will manifest in the economy, as well as for companies and for individual homeowners and home buyers.

Today's hearing is designed as a learning opportunity rather than a policy discussion. Therefore, we have invited some of the leading housing researchers to testify.

First we will hear from Patrick Lawler, chief economist at the Office of Federal Housing Enterprise Oversight. Just last week OFHEO released the updated housing price index, which showed the largest deceleration in three decades. This recent housing data, as well as OFHEO's extensive historical data will be very helpful in today's discussion, as well as projections for the future.

Next, we will hear testimony from Rich Brown, chief economist for the Federal Deposit Insurance Corporation. The FDIC has done extensive analysis of market trends, including a specific analysis of whether and when booms are followed by a bust. This information will help us evaluate our current situation.

Our third witness will be Dave Seiders, chief economist of the National Association of Homebuilders. As you might imagine, the Homebuilders collect extensive information on their industry, which provide important insight into the industry's future.

Finally, we will turn to Tom Stevens of the National Association of Realtors. Just as the Homebuilders, the realtors are in a position to collect and track extensive industry data through its 1.3 million members.

All four organizations are among the leading housing researchers and have compiled extensive data. No doubt this information will be extremely helpful as members try to better understand housing and its economic implications.

I will now turn to my ranking member, Senator Reed.

Senator REED. Mr. Chairman, may I yield to Senator Schumer?

Senator ALLARD. You may.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Well, thank you, Mr. Chairman. I apologize.

First, I thank you and Senators Bunning and Reed for having this hearing and I am happy to join in. I apologize. I will only be here very briefly, and I would ask unanimous consent that my entire statement be put in the record.

Senator ALLARD. Without objection, so ordered.

Senator SCHUMER. I will just make a brief point. I guess, to paraphrase Shakespeare, is there a bubble or isn't there a bubble? That is the question. And we all know housing markets are not growing as vigorously and, in some places, declining a bit, but will there be a soft landing or will the bubble burst? That is a very important question for our economy for the next few years, and to learn what things we can do to decrease the likelihood of bubbles. And one of the things I am particularly concerned with is actually relates to our next hearing, which is on mortgage products and too many people pushing mortgages that people cannot really afford, the kinds of loss leaders and other kinds of things that are put in to the various types of reverse mortgages and other kinds of things around—not reverse mortgages, but no-interest mortgages, no principle mortgages, are really troubling.

So, I look forward to reading everybody's testimony. It particularly affects my area of New York, where we have amazing growth in housing prices. We bought our coop in 1982, and you can add a zero to it. That is about the most important thing we own in New York, in terms of its value.

I look forward to hearing the testimony of everyone. Again, I apologize for not being able to stay.

Senator Bunning.

OPENING STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Chairman Allard.

I am glad to be co-chairing this series of hearings with you as we examine current issues in the housing market. Today's hearing is on the state of the housing market and what it means to the economy.

Some people, especially in the media, suggest that there has been a housing bubble and it is about to burst. Others think we are in the middle of a normal economic cycle and that the market will take care of itself over time. I hope our witnesses can shed some light on these views today. Clearly, the housing market has been hot the last few years. It is also clear that the market is cooling now, although it is not as clear how fast or how long-lasting that cooling will be. It is important to point out that not all parts of the country have experienced the same price changes. The coasts have seen rapid home price increases, while, in the middle of the country, home prices have increased at a slower and more constant rate.

For example, in my State of Kentucky home prices have increased about 25 percent over the last 5 years, while here in Washington, D.C., home prices have increased about 120 percent. So, while the bubble could be about to pop in some parts of the country, a nationwide collapse in home values, in my opinion, does not seem likely.

Even though a nationwide housing bust may not happen, a rapid cooling in overheated markets could have implications for the entire economy. For example, consumer spending accounts for over two-thirds of the U.S. economic activity. Therefore, to the extent that consumer spending has been supported by increased home values, any stall or decline in home values appreciation could be very troublesome. A declining market has already hurt the profits of homebuilders and that could spread to related industries, as well.

Furthermore, a wave of defaults could hurt the financial sector and the overall economy. That could happen if lenders loosen their credit standards in order to write more loans or if mortgage interest rates continue to climb thanks to the Federal Reserve interest rate hikes.

At this point, it is hard to tell what the full impact of interest rates will be because of the large number of non-traditional mortgages written lately. We will look more closely at that topic next week. We also have to look at how we got here. Housing prices began to climb in 1997 and picked up the pace in 2003. It was not until this year that nationwide averages have begun to seriously slow. The tech burst in 2000 left people looking for somewhere other than the stock market to put their investment money, and a lot of that money went into housing.

The Federal Reserve began cutting interest rates in early 2001, eventually taking the overnight Fed rate to 1 percent in 2003. Former Chairman Greenspan kept rates at this historically low level for a year before beginning the 2-year string of increases that just ended last month. That period of extreme low interest rates makes the beginning of the most rapid acceleration of the housing boom and caused part of it. I think it is clear that the Feds actions contributed to the housing boom and that more recent actions will turn out to be a key factor in the slowdown.

Many other factors must be examined, as well. Americans' appetite for bigger and nicer homes has no doubt pushed up the prices. The growing population and the increased wealth of the Baby Boom generation has contributed to increased housing demand. Congress made home ownership more beneficial starting in 1997 when most homeowners no longer had to pay tax on the proceeds of the sale of their primary residence.

There is no doubt many other factors that have contributed to the current state of the housing market. We do not need to be concerned with factors that contributed to normal market forces, but if the market has moved because of unsustainable or artificial forces, we may be in for a rough ride.

I want to thank all of the witnesses for coming today. I will look forward to hearing from them and to exploring this important topic.

Senator ALLARD. Thank you.

Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman, and Chairman Bunning, for holding this very timely hearing on the housing bubble and its implications for the economy.

For the past several years, a booming housing market has been one of the few sources of strength in our economy. That strength has come not only from homebuilding activity itself, but also from the household spending supported by rising home values and increased home equity wealth.

What we are seeing now, however, are clear signs that the housing boom is cooling off. What we would like to explore in this hearing is how this process is likely to play out. Will there be a smooth economic adjustment to a housing market with a slower pace of home building and house price appreciation or will the popping of the housing bubble be accompanied by serious economic disruptions and flat or even falling housing prices?

A wide range of recent data points to a distinct cooling in the housing market. Residential investment peaked in the third quarter of last year and has declined since, directly lowering economic growth. In the second quarter of this year residential investment at a 9.8 percent annual rate, the largest quarterly decline in more than a decade, and directly shaved .6 percentage points off the economy's overall growth rate for the quarter.

Current indicators of homebuilding also point at the possibility of further declines. The number of housing units started in July was 13.3 percent lower than it was a year earlier. The number of authorizations for new housing construction was down 20.1 percent, the largest drop since the recession of 1990. Sales of single family homes in July were 13.2 percent below their level a year earlier.

Moreover, the supply of new single family homes available for sale rose to equal six-and-a-half months of supply at the current sales rate, the highest ratio of houses available to sales in more than a decade. So far we have not seen the collapse of housing prices, although the rate of increase has slowed dramatically. After rising 12.9 percent in 2005, the median price of existing homes published Mr. Stevens group, the National Association of Realtors, rose a scant .9 percent over the 12 months ending in July.

Mr. Lawler's office, OFHEO, has a price index that is constructed differently, but tells a similar story of sharply decelerating home prices over the past four quarters. A striking feature of the housing boom and its recent slowing is its regional character. Prices went up dramatically in some States in 2001 to 2005, but much less so in others. Now that prices are coming down, the most pronounced slowing has occurred in those areas that experienced the greatest increases, while areas that never had a boom do not seem to be experiencing a bust either.

What happens to the housing sector and home prices is of enormous concern to ordinary Americans, for whom their house is, by far, their most important source of wealth. It is also a concern for the people in the construction, real estate, and mortgage lending businesses, whose livelihood depends upon a very healthy housing sector. And it is a concern for the overall economy. I hope the economy can make a smooth transition to a more sustainable pace of housing activity and house price increases without going through the turmoil that is often associated with the bursting of an economic bubble.

But I worry that the economy may be headed for a bumpy landing. As long as the Bush Administration refuses to take any serious action to address other challenges in the economy, especially our fiscal and trade imbalances, we cannot count on strong business investment or an improving trade balance to offset the loss of housing-based spending.

I look forward to the testimony of our witnesses today to help us understand this situation as we approach it over the next several months.

Thank you, Mr. Chairman.

Senator ALLARD. OK, the Committee plan at this point is that we will go ahead and start with the testimony from the experts at the panel and then I will turn the gavel over to Senator Bunning to be in charge the rest of the meeting.

Mr. Lawler.

STATEMENT OF PATRICK LAWLER, CHIEF ECONOMIST, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Mr. LAWLER. Thank you very much Chairman Allard, Chairman Bunning, Ranking Member Reed.

I am pleased to be here, where I enjoyed working as a Committee staff member some years ago, to testify on housing market developments and prospects. OFHEO has a strong interest in housing markets and particularly in house prices because they have a powerful effect on the credit quality of mortgage loans owned or guaranteed by Fannie Mae and Freddie Mac, the enterprises we regulate.

Over the past 5 years we have witnessed an extraordinary change in the relative price of houses. The general level of house prices soared 56 percent from the spring of 2001 to this spring. And the prices of other goods and services rose much less, so that inflation-adjusted house prices are now 38 percent higher than 5 years ago. That exceeds the inflation-adjusted increase in house prices from the previous 26 years, going back to the beginning of our data in 1975.

A number of factors have contributed to these price gains. Long-term mortgage interest rates fell from about 8 percent in mid-2000 to less than 6 percent from early 2003 to mid-2005. Short-term rates declined by more, and borrowers took advantage as more of them took out adjustable rate loans. Interest only and negative amortization loans provided even lower monthly payments. The spread of these products helped stimulate demand as did the rapid growth of sub-prime lending.

Demographics have also been favorable. Aging Boomers are reaching their peak earning and investing years, with many interested in second homes for vacations or future retirement. Immigration has accelerated household formation. Supply constraints have made it difficult to meet the increased demand, lengthening the time necessary for builders to bring new houses on the market and raising the premiums paid for prime house locations.

Finally, there is some evidence of speculation, including a higher share of loans made to investors and anecdotes of property flipping. Certainly the poor performance of the stock market early in this decade was in obvious contrast with the investment performance of houses, and that may have encouraged some shift in investor focus.

House price increases have been uneven across the nation, though. While homeowners in Indiana, Ohio, and Michigan have seen their house values over the past 5 years in constant dollars roughly stay the same, residents in Florida, California, and here in the District of Columbia have watched prices virtually double, even after adjusting for inflation.

Over the past year, the pace of house price inflation over most of the country has moderated dramatically. The sharpest decelerations have come in some of the most superheated markets of a year ago. Nationally, prices rose in the second quarter of this year by less than the inflation rate of other goods and services in the economy.

Other market indicators confirm the general chilling of housing markets across the nation. Particularly noteworthy is the swelling inventory of unsold houses on the market, which has risen from less than 3 million houses to about 4.5 million in, roughly, the last year-and-a-half. The sales rates have fallen at the same time, so inventories relative to sales are now the highest since the early 1990s.

Historical patterns of price behavior in housing markets may provide some guidance about potential future developments. OFHEO's national house price index has never fallen over a period of a year or more, but it has come close, and inflation-adjusted prices have fallen significantly, by 11 percent in the early 1980s and by 9 percent in the early 1990s.

In the first instance it took nearly 8 years for inflation-adjusted prices to regain their past peak, and in the second case almost 10 years. Certainly a similar event is quite possible now. Cycles in inflation-adjusted home prices have occurred in a much more pronounced way in some cities, such as Boston and Los Angeles. The cycles stem from the effects of local business cycles, the delays in the response of supply to increased prices, and, to some extent, from speculation.

Over much of the country fundamental factors have pushed up demand and accounted for at least a large portion of the price increases of recent years. However, increasing supply, higher interest rates, and a turn in market psychology may cause prices in some markets to fall. In the past, significant nominal price declines have generally been associated with local or regional economic recession, but the exceptional size of some of the recent increases could make them vulnerable without a recession.

In the long run, I expect housing markets to perform well, especially if immigration continues at recent rates. An important caveat, though, is that healthy housing markets could soften seriously from an unexpected disruption in the ability of Fannie Mae and Freddie Mac to function effectively in secondary markets.

OFHEO is currently focused on correcting the significant accounting, internal control, management, and corporate governance weaknesses identified at both companies through OFHEO examinations. While both companies have made progress, much more needs to be done. It is apparent that, in order to insure the long run safety of these two GSEs, the regulatory framework must also be strengthened.

OFHEO supports the enactment this year of legislation that will create a new regulator with adequate funding, bank-like regulatory and enforcement authorities, and encompassing not only safety and soundness, but also mission regulation.

Thank you. I will be happy to answer any of your questions.

Senator BUNNING. Mr. Brown, go right ahead.

STATEMENT OF RICHARD BROWN, CHIEF ECONOMIST, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. BROWN. Thank you. Chairman Allard, Chairman Bunning, and Senator Reed, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation concerning housing market trends and their implications for the economy. Like the other panelists testifying today, the FDIC closely monitors current conditions in U.S. housing markets.

I would like to focus my oral statement on recent FDIC research into housing boom and bust cycles in U.S. metropolitan areas over the past 30 years. I believe these results may provide useful context on the topic of today's hearing.

The FDIC monitors trends in U.S. home prices and mortgage lending practices as part of its risk analysis process. FDIC-insured institutions are extremely active in just about every aspect of housing finance. These activities have helped the industry to post record earnings for five consecutive years.

Credit losses for the industry remain low by historical standards, while capital levels remain high. No FDIC-insured institution has failed in over 2 years. However, our experience in the late 1980's and early 1990's showed that banks and thrifts are subject to potentially large credit losses arising from boom and bust cycles in real estate. This experience was the motivation for our recent studies of metropolitan area home price trends.

In this research, FDIC analysts asked three simple questions. Where have booms occurred? Where have busts occurred? Does boom necessarily lead to bust?

Using the OFHEO house price index series, our analysts attributed a housing boom to any metropolitan area that experienced at least a 30 percent price increase, adjusted for inflation, during a given 3 year period. A housing bust is defined as a 15 percent decline in nominal terms over a five year period.

We use a 15 percent price decline to define a bust because it would be enough to wipe out the equity of recent homebuyers who made only a 10 percent down payment and would seriously impair the equity of those who put 20 percent down. Given that about two out of five first time homebuyers last year effectively received 100 percent financing, a 15 percent price decline could be expected to have significant adverse credit implications for mortgage lenders and investors.

Applying these standard definitions for booms and busts over the period from 1978 through 1998, we observe that movements in home prices tend to be long-term trends that play out over years. We also see that true housing busts are relatively rare events, with only 21 such episodes recorded since 1978.

But of the 54 individual housing booms recorded during this period, only 9 resulted in a subsequent housing bust, according to our definitions. Housing booms have typically been followed by an extended period of stagnation where prices may, in fact, fall, but usually not by enough to meet the FDIC's definition of a bust. Where housing busts did occur they were usually associated with episodes of severe local economic distress, such as the energy sector problems experienced in Houston in the mid-1980's.

While these findings are somewhat reassuring from a risk management perspective, we need to keep in mind that the periods of stagnation that typically follow booms can be painful for homeowners, investors, and real estate professionals. Measures of housing market activity, such as home sales and construction, tend to suffer larger declines than home prices themselves.

The fact that current homeowners are very reluctant to sell at distressed prices during these episodes unless they are forced to helps to explain why home prices tend to be what economists call "sticky downward." Our analysis also points to two important trends that distinguish the current situation from our historical experience. First is an increase in the number of boom markets to unprecedented levels, from a then record high 40 markets in 2003 to 89 individual markets in 2005. Second is the sweeping change that is taking place in the structure of mortgage loans. Since 2003, we have seen borrowers migrate toward adjustable rate, interest only, and payment option structures where monthly payments may start out low, but can increase substantially if interest rates rise, or as low introductory interest rates expire. By some estimates, interest only and payment option loans made up between 40 and 50 percent of mortgage originations during 2004 and 2005.

In conclusion, FDIC's studies find that housing price booms do not inevitably lead to housing price busts, and that severe local economic downturns continue to pose the greatest downside risk to local home prices. While mortgage credit performance at FDIC-insured institutions remains excellent at present, we will continue to monitor these portfolios as this decade's great housing boom inevitably subsides.

This concludes my testimony, I will be happy to respond to any questions the Subcommittees might have.

Senator BUNNING. Thank you very much.

Mr. Seiders.

STATEMENT OF DAVE SEIDERS, CHIEF ECONOMIST, NATIONAL ASSOCIATION OF HOMEBUILDERS

Mr. SEIDERS. Thank you, Chairman Bunning, Chairman Allard, Senator Reed.

My full statement outlines my view of the basic causes of the 2004–2005 housing boom and the current housing downswing. It also estimates the depth and duration of the downswing and discusses the likely economic impacts of the downswing in housing market activity, as well as from some secondary housing effects, like the weakening of the housing wealth effect that has already been mentioned.

I think the first thing you will recognize is that the housing boom of 2004–2005 and the current housing downswing have some really unique features that make these episodes different from previous housing market swings. Three big differences that I see are, first, unusually stimulative financial market conditions before and during the boom. Second, record breaking increases in inflation-adjusted, or real, house prices. And third, an outsized presence of investors or speculators in both the single-family and the condo markets.

To put things in perspective, the current contraction, in my view, amounts to an inevitable mid-cycle adjustment or transition from unsustainable levels of home sales, housing production and house price appreciation, to levels that are supportable by underlying market fundamentals, that is, primarily by demographics and household income trends.

With respect to timing, the previous boom involved more than 2 years of unsustainable housing market activity. And we are likely to experience a below trend performance of home sales and housing starts of roughly similar duration. We expect the downswing to bottom out around the middle of next year before transitioning to a gradual recovery that will raise housing market activity back up toward sustainable trend by the latter part of 2008.

Regarding house prices, national average price appreciation is likely to be quite limited in the near term as the housing market weakens. Indeed, some decline is a distinct possibility in coming quarters. The rate of price appreciation should remain below long-term trend for some time into the future in nominal terms. Real house prices, adjusted for general inflation, are likely to fall to some degree on a national average basis following the unprecedented surge of recent years.

In terms of economic impact, the downswing and home sales and housing production will continue to detract from overall economic growth through mid-2007. However, much of this negative impact should be offset by strengthening activity in other sectors of the U.S. economy, keeping GDP growth reasonably close to a sustainable trend-like performance. These sectors include non-residential fixed investment, including non-residential structures, as well as our trade balance.

There are bound to be some adverse secondary impacts of the ongoing housing contraction. These effects include, first, less support to consumer spending from the housing wealth effect. Second, the impacts of payment shock on homeowners facing upward adjustments to monthly payments on various exotic or non-traditional types of adjustable rate mortgages.

At this point, my judgment is that the size and timing of these two effects are not likely to seriously threaten the economic expansion in the next few years. My bottom line is that the evolving housing cycle will definitely exert a serious drag on the economy through several channels, but that the U.S. economy should avoid outright recession during the 2006–2008 period.

I should point out that there are significant downside risks to this outcome, and I have outlined a number of these risks in my full statement. To mention a few, there is always the possibility of spikes in interest rates or energy prices. I have got both of these factors behaving rather quietly in my baseline forecast. Another major risk is that there could be wholesale resales of housing units back on to the market by those investors or speculators that purchased them in the last couple of years. On the exotic ARM and the payment shock issue, there clearly are major uncertainties about the dimensions of that. I am glad to hear you are having another hearing on that shortly. I will also say that there are major uncertainties about the actual accurate size of the inventory of the new homes for sale on the market.

That concludes my oral remarks. I will be happy to take any questions. Thank you.

Senator ALLARD. Mr. Stevens, please.

STATEMENT OF TOM STEVENS, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS

Mr. STEVENS. Thank you Chairman Allard, Chairman Bunning, Senator Reed, and Senator Carper. I appreciate the opportunity to be here and represent our 1.3 million members of the National Association of Realtors.

For the past 5 years the housing market has been a steadfast leader in the U.S. economy. In 2005, mortgage rates remain near 45 year lows, and the nation's economy generated 2 million new jobs. Existing home sales and new single family housing starts also set new high marks in 2005. Overall, the housing sector directly contributed more than $2 trillion to the national economy in 2005, accounting for 16.2 percent of economic activity.

After 5 years of outstanding growth and being the driving force of the U.S. economy, the housing market is undergoing a period of adjustment. Existing home sales in July have fallen 11.2 percent from a year ago. New home sales are down 22 percent from a year ago. What is especially striking is that the inventory of unsold homes on the market is at an all time high at 3.9 million, which is a 40 percent rise from just a year ago.

Given the falling demand and increased supply, home prices have seen less than 1 percent appreciation from a year ago, compared to double digit rate of appreciation in 2005. While recent market changes raise concerns, it is important to remember that the housing market varies significantly across the country. One-third of the country is still seeing rising home sales. These places include Alaska, Vermont, New Mexico, and States in the South, with the exception of Florida. The remaining two-thirds of the Nation are experiencing lower sales, with some States feeling acute adjustment pains. Sales are down significantly in Florida, California, Arizona, Nevada, Virginia, and Maryland.

These regions experienced the greatest rise in home prices in recent years. Affordability has become a major issue for homebuyers in these markets, as well. The decline in sales has resulted in higher housing inventories or tripling and quadrupling in some cases. These areas are the ones most vulnerable to outright price declines, particularly if interest rates continue to increase.

Contrary to many reports, there is not a national housing bubble. All real estate is local. For example, the housing market in California is extremely different from the housing market in Oklahoma. Home priced income ratio, home priced to rent ration and, more importantly, mortgage debt servicing cost to income ratio have greatly increased in some housing markets to unhealthy levels. Markets in Florida, California, Arizona, Nevada, Virginia, and Maryland have exhibited trends far above the local historical norm.

Because of these exceptional trends, it would not be surprising for these markets to experience a price adjustment, and we are starting to see that in some of the areas. However, these States have solid job growth. Price declines are likely to be short lived in a period of solid job growth as new job holders enter the housing market.

If mortgage rates were to rise measurably to, say, 7.5 percent or 8 percent from the current 6.5 percent for whatever reasons, then the housing market would certainly come under more pressure, and many markets would likely undergo price declines. Rising mortgage rates are the most influential factor in the housing market coming under more pressure.

Many home buyers in coastal markets have resorted to more exotic mortgages as the only way to enter the housing market. For some buyers this has meant financing their home through interest only, adjustable rate, or option ARMs. These buyers are at their financial capacity. With raising interest rates, homebuyers have become exhausted financially, which explains why sales have tumbled in high priced regions of the nation.

This is where we are in the housing market to date and how we arrived to this point. The national forecast for the coming year, based on stabilizing mortgage rates and a modestly expanding economy through 2007 predicts that existing home sales will fall 8 percent in 2006, followed by another 2 percent decline in the following year 2007.

New home sales will fall by an even greater amount of 16 percent in 2006, and then 7 percent in 2007. Home price growth will be minimal or less than 3 percent in 2006 and 2007. However, some markets will have higher or lower rates of appreciation as compared to the national forecast. All real estate is local and based on local economic conditions. Also, it is important to understand that any significant shift in mortgage rates and the change in the economy will change the forecast.

We also expect that spending on residential construction as part of the economy will drop 3.4 percent in 2006, and 8.5 percent in 2007. In other words, our nation's economy will lose $21 billion from the GDP this year, and another $49 billion in 2007. This is a sharp contrast to the near $50 billion in added economic power during the housing market boom of the last 5 years.

The housing market also supports consumer spending for items such as furniture to cars, travel, education. All of these spending items have been supported by increases in housing equity over the past several years. The housing sector also directly employs real estate agents, mortgage lenders, construction workers, and is responsible for the expansion of home improvement retail stores such as Home Depot and Loews.

In the past 5 years, a typical homeowner gained $72,300 in housing equity, including over $20,000 in the past year. Nearly all economists would agree that consumer spending has been far more robust than can be explained by income growth, job gains, and stock market gains. GDP growth would have been 1.5 percentage points lower had the housing market not provided the wealth accumulation in recent years.

As the nation's leading advocate for home ownership, affordable housing, and private property rights, realtors understand that the housing sector could not maintain the record-setting pace indefinitely.

We believe that a soft landing is possible and, under the right circumstances, likely. But a soft landing is dependent upon policies that support a transition to a more normalized market and work to mitigate changes in local markets so that affordable mortgage financing is available to home buyers.

And we stand ready to assist the Congress in any way to help continue the dream of American homeownership.

And I would, Mr. Chairman, like to support for the record—our chief economist could not be here, but he has a PowerPoint presentation——

Senator BUNNING. Without Objection.

So ordered.

Mr. SEIDERS. Thank you.

Senator ALLARD. Thank you, Chairman Bunning.

Mr. Brown, you talked about some of the differences between the current growth and value of homes and where we begin to see that drop down—actually rate of growth decrease in many areas. You compared that to previous experiences and talked about the market devaluation increases as a difference, and also you mentioned mortgage instruments changed considerably as a difference.

And perhaps Mr. Seiders would also like to comment on this. But we have also, it seems to me, experienced a pretty good jump in raw material, right now. The cost of raw materials that are going into a home—I think the last couple of years, at least in my State of Colorado it has increased 10 percent, and you did not mention that. I am wondering what other factors that you, perhaps, did not mention that you would like to elaborate on, and I am particularly interested in the raw materials issue.

Mr. BROWN. And that is in terms, Mr. Chairman, of the difference between today's situation and previous booms?

Senator ALLARD. Yes. You use the terms boom and bust and define those——

Senator BUNNING. Please bring your mic up just a little bit so that we can hear better.

Senator ALLARD [continuing]. And you were talking about today's housing issues as compared to previous boom and bust periods.

Mr. BROWN. That is right.

Well, Mr. Chairman, the historical cycles that we are looking at never replay themselves in exactly the same policy environment or the same economic environment. Clearly, the commodity price increases that you are speaking of are important in today's environment. And the structure of mortgage lending is another important factor. I would emphasize that with the big changes we have seen as mortgage lending technologies and instruments have evolved over time, you have a vastly different institutional environment today than you had in the booms in the 1970's and the 1980's.

I do think that there are three reasons to believe that our experience going forward may be similar to what we have seen in previous booms. First is the consistency of the results that we have seen over time. Second is the behavioral rationale for the fact that prices are "sticky downwards" or they tend to go down slowly, with homeowners very reluctant to sell at disstressed prices. And the third reason is that these episodes of severe local economic distress, such as Houston in the mid-1980's, have proven to be relatively rare and especially so since the rolling regional recession of the 1980's.

Senator ALLARD. Mr. Seiders.

Mr. SEIDERS. Yes, Mr. Chairman. That gives the opportunity to mention a few things.

I consider the virtual explosion of house prices in both nominal and real terms in 2004 and 2005, even in 2003, to be primarily a demand-driven phenomenon. Having said that, one of the factors that exacerbated the upward price movements was, and still is, pretty serious supply constraints in a lot of the markets where we have seen the biggest price increases to date, meaning land use controls, difficulty for the builder to bring more supply on to meet the surge in demand.

In terms of the costs of production, there is a long-run relationship between what I will call the replacement cost for housing and all house values, both new or existing. They sort of have to gravitate together over the long-term. We have seen large increases in the prices of the bundle of building materials that is used in homebuilding. There is a producer price index, subcomponent for that package of materials that's running at pretty rapid rates even at this time, for very different reasons for different parts of the commodities markets. But again, mainly a demand-driven phenomenon exacerbated by supply constraints in a bunch of places.

If the cost increases should continue to run this high or even run higher, over the long-term we may see more upward pressure on house values than I have in the forecast.

Senator ALLARD. Now, we have seen some dramatic increases in home prices and mortgage costs. In fact, thinking back on my investment, I think my home investment has probably been better than any stock market investment I have ever made. I was fortunate enough to be in a home at the time.

How are credit and lending standards influencing these scenarios where we see increases in both home prices and mortgage costs outstripping income growth?

Mr. BROWN. Well, we certainly saw an intensification in the home price increases in 2004 and 2005. In 2005, we saw U.S. prices, on average, rise three times faster than disposable income. That is a disparity that we have not seen before. Also, the expansion in the scope of the boom was unprecedented. And certainly the prevalence of some of the non-traditional mortgages, the interest only and payment option loans, was greater in the boom markets than it was in other parts of the country.

One of the rationales is that people have been using these instruments to qualify for homes in high-priced markets. It is a way for them to stretch what they can afford.

Mr. LAWLER. Certainly, the availability of mortgage credit has never been greater. Sub-prime lending, I think is part of that, as well, taking 20 percent of the market in the last couple of years, which is a big change from just a few years ago.

Senator ALLARD. I did not realize it was 20 percent of the market. Significant.

Any other panel comments? My time is expiring here.

Mr. STEVENS. I would just comment that the housing affordability, which is key, has shifted and started to turn. We were just under 70 percent of all Americans owning a home up until this turn in the housing market started a year, a year-and-a-half ago.

So, the two things that have affected that are the raise in rates and the appreciation and home values, the vast appreciation. So, the affordability index has turned.

Senator ALLARD. Thank you, Mr. Chairman.

Senator BUNNING. Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Thank you, gentlemen, for your testimony.

Most economic forecasts suggest as you have that there will be a decline, in terms of economic housing activity over the next year. Goldman Sachs economists are forecasting a housing slowdown, which would shave about 75 basis points off the overall growth in 2007. I think that is consistent with your comments.

And they have also suggested the OFHEO price index would likely decline about 3 percent.

So, Mr. Lawler, do you think it would decline by about 3 percent, your price index?

Mr. LAWLER. That our index will decrease 3 percent——

Senator REED. Yes.

Mr. LAWLER [continuing]. Over the next year?

We have not made any specific point forecasts. We are more concerned with what is the worst that can happen. Certainly something like that could happen. It is a matter of concern for us. We have never seen anything like that in the past, but we recognize there are aspects of the run up that we have seen in the last few years that are unprecedented.

Senator REED. So it is a possibility that you have not yet concluded, then?

Mr. Stevens, in that vein, you talked about the regional characteristics of the housing market, prices appreciating and depreciating, but could you see a national decrease in housing prices on the order of 3 percent or less, but a national housing decrease in prices.

Mr. STEVENS. Well, I think, overall, you take all of the different pockets across the country and you are going to have an average amount. So, yes, you are probably going to see some kind of a percentage decrease. I think what is critical to whether we are talking bubble burst or not is the rate increases. I think that we are sitting right on a fence where the Fed has stopped raising rates. I do not think that could have come any later. We are hoping that it came in time, and it is our feeling, and our chief economist, David Lereah, who, unfortunately, could not be here, is that if those rates start to rise again that will dictate whether we slide off that fence into a challenging recession, bubble burst-type situation.

Senator REED. Thank you.

Mr. Seiders, again, thank you for your testimony. You talked about, in the longer term, beyond 2007, of compensating economic factors that would make up for this slowing market you suggested, trade balance and non-residential structures. Would you care to comment on that?

Mr. SEIDERS. Yes. This is a puzzle, obviously. This is one of these mid-cycle rotation processes that I am counting on. Actually it applies to 2006 and 2007, primarily, and maybe into 2008. We do definitely expect, this year, all of it, and at least half of next year, for the housing production component of GDP to be in retreat, stabilizing, hopefully, around the middle of the year.

I am counting on business spending on capital equipment and software, as well as non-residential structures to be in stronger growth phases than they had earlier. I am also expecting our trade balance to be improving. Now, I realize that we have recently gotten some troublesome numbers on both of those fronts. So, it is hard to be exactly sure it is going on out there. And that is, obviously, one of the downside risks that I would list to the forecast that I have.

Senator REED. So, if the compensating factors of the improved trade balance and business investment do not materialize, then this housing will pull down GDP even further?

Mr. SEIDERS. There is no doubt about that. That would be a much more serious economic picture than I have penciled in or, I would say, the Blue Chip panel in general.

Senator REED. Let me ask a question, both to you, Mr. Seiders, and Mr. Brown, about foreclosures. Data that was released today has seen an increase in foreclosures, particularly in the hot markets like Nevada.

How do you factor in foreclosures in terms of your views?

Mr. SEIDERS. Well, I try to factor in, as I mentioned very briefly in my statement, the impact of payment shock on consumers that have these mortgages that are going to come home to roost. They are coming home to roost now and will later. There are not only strains on household budgets in store, but also prospective defaults on loans and so forth.

In my forecast, I had that being a manageable factor. I do not expect that those default rates are going to move up all that much, but it is another very gray area. And the thing that really bothers me about this is, we can tell, roughly, how many loans were originated with payment-option features, with negative amortization or interest-only loans or things like that. What we cannot tell is how various features were layered on top of each other. You could have a payment-option mortgage allowing for negative amortization. You could have, on top of it, a piggyback second written who knows how. It could be a no-documentation loan—so forth and so on.

So, again, in my forecast, I have got minimal negative economic impacts from this phenomenon, but it is another area of substantial uncertainty.

Senator REED. Thank you, Mr. Chairman.

Will we have a second round?

Senator BUNNING. I hope so.

I am going to take my 5 minutes now.

Mr. Lawler and Mr. Brown. Clearly interest rates play an important role in affordable housing. The lower the interest rate on mortgage, the more house a buyer can get for their monthly payment. I think it is clear that rate cuts by the Fed are what helped drive the housing boom.

What role do you think lower interest rates enabled by the Fed rate cuts played in heating the housing market and driving up prices? And, specifically, do you think Fed rate cuts from 2001 to 2003, especially the decision to leave rates at 1 percent for a full year, are the most significant factor in driving up house or home prices?

Mr. LAWLER. I think they are the most significant factor during that period. Not only did they help lower long-term interest rates, but they increased the use of adjustable rate mortgages focusing on extremely low short-term interest rates and stimulated some of the investor psychology, which added on top of that. It also encouraged some of the increased use of other mortgage types, option ARMS, interest only loans, that really make investment especially easy.

So, I think they were the most important contributor.

Senator BUNNING. Mr. Brown.

Mr. BROWN. Mr. Chairman, I would certainly agree that interest rates are a very important component to housing affordability. It is not just the short-term interest rates, which were at generational lows during the early part of this decade, but also long-term interest rates, which also were at generational lows, and still remain lower than what we have seen at similar parts of previous business cycles.

This has been attributed in some quarters to heavy investment by the foreign sector of U.S. Treasury and mortgage instruments. That has helped keep long-term mortgage rates down and also has helped to boost housing activity from where it otherwise would have been.

Senator BUNNING. Now, this is the second part of the question I just asked the regulators, for Mr. Stevens and Mr. Seiders.

Just as the Fed rate cuts helped drive the housing boom, the 17 straight rate increases from June 2004 to 2006 contributed to the recent slowdown. However, home prices continued to climb and even accelerated while the Fed was increasing interest rates. That suggests that there is a lag between their action and their impact on the market.

What impact have the Fed rates increases from 2004 to this year had on the housing market? And do you think that the full effect of those increases has been felt yet?

Mr. SEIDERS. Well, first of all, the string of rate increases until early this year was basically getting back to or toward monetary neutrality. It had to be done.

During most of that period, the long-term rates still remained stubbornly low, I think to the Fed's chagrin, at times, largely because of the international financial market picture. The Fed is now into the restrictive zone on monetary policy. There are definitely fairly long lags in the impacts of monetary policy on the interest-sensitive sectors, including housing.

That is why we have been strenuously encouraging the Fed, since before the August 8th meeting, to please stop. We will see how this evolves going forward. In my forecast, my next change in Fed policy is rates moving downward, but that is not until toward the middle of next year.

So, it is very important how the Fed manages monetary policy as we go forward. They know very well that they have a lot in the pipeline with a lot of lag to have to worry about.

Senator BUNNING. Mr. Stevens.

Mr. STEVENS. I echo what Mr. Seiders said and I am in agreement. It does have a direct effect.

To answer the lag question, I truly do think, based on history and past economics, that we will see a continued decline in house values. We certainly have not bottomed out, yet. There is a lag there in the raising of the rates. That lag will follow, and prices will continue to decline.

Senator BUNNING. Last, do you think if the Fed resumes their increases, that they are going to go over the top and send our economy the other way rather than flattening out, sending it on a cycle down?

Mr. SEIDERS. If I had to pencil into my forecast Fed tightening from here forward, I would have to definitely lower both the housing and the economic outlook.

Mr. STEVENS. And I already said the same thing.

Senator BUNNING. OK.

Senator Carper.

Senator CARPER. Thanks very much. Going back to the reason there was such a spike in housing prices in, you said, 2003, 2004, 2005, and a moderation today, was part of that driven—you may have said this and I missed it—was part of that driven by a flight from equities, as people on the heels of Enron and other financial disasters we know a lot about in this Committee drove a lot of people out of equities? And they are looking for a place to put their money. They put it, in some cases, improvements in their own homes. In other cases, they put it in second homes.

Mr. LAWLER. I definitely think that that is a contributing factor. The performance of the stock market earlier in this decade was weak. And, as Boomers were reaching their prime earning and investing years, more turned toward housing, thinking about retirement homes and vacation homes as a way to combine two things at one time, investment and something to be used. And that fed on itself as the house increases made housing look like a really good investment in comparison.

So, I think the psychology was favorable to housing for a while. And it has continued for quite some time. It is probably changing now.

Mr. SEIDERS. If I might add on that, yields on fixed-income investments were obviously at very rock bottom, both short and long-term.

Senator CARPER. Mr. Stevens.

Mr. STEVENS. I echo both comments by the two gentlemen prior to me. I think there was a flight from the financial markets.

And then, also, I think wealth accumulation. You had 40 percent of the properties sold in 2005 were investment properties, second homes and investments, vacation homes. So, there was a lot of wealth accumulation and people saw the value and appreciation in real estate and moved to that market.

Senator CARPER. What are the implications for second homes, for vacation homes, going forward for the next year or two or three?

Mr. STEVENS. Well, I think that housing—I will jump in—that market is still very strong and robust. There is still a lot of Baby Boomers looking to invest in that property. The challenge that I think you have today is the coastal areas where most of them, percentage-wise, want to be near water. You have got flood insurance challenges. They cannot get insurance.

And, as I stated in my testimony, you cannot get a mortgage if you do not have insurance. So, they are looking to these sub-prime-type lending products and that starts another challenge in the marketplace.

Senator CARPER. All right.

Mr. Seiders.

Mr. SEIDERS. I am worried to some degree about the bona fide vacation, resort area issue, although it is worth remembering that the Baby Boom generation, which now is in its stage where they have a lot of the wealth of the country, are still going to want those kinds of units.

What I worry most about, on the investment side, is that we know a lot of the investors were, in fact, speculators. They had no intention to be using the units even as vacation properties, or even as rental properties. My builder surveys are telling me that we are seeing a good number of sales contracts to those kinds of buyers canceled before closing. And now we are seeing some resales of units bought by investors for short-term speculative purposes being resold back on to the markets.

I think, from a market perspective, that is one of the big risks that I have in the back of my mind.

Senator CARPER. OK. Thank you.

Mr. LAWLER. We are seeing in a number of areas in Florida, for example, huge increases in inventory sales ratios in vacation areas.

Mr. BROWN. I would emphasize that the long-term demographics appear to be quite positive. Again, with the maturing of the baby-boom generation and the desire for second homes, housing is coming to be viewed more as a luxury good, prompting more investment in such housing.

In addition, many of these boom economies have boomed before. These are places where people want to be, that are adding jobs, and that have fairly vibrant economies.

Senator CARPER. Thank you all.

My other question, and I would like to start with you, Mr. Stevens, and then just go to each of the other panelists if we could. We have grappled with the issue of GSE reform, trying to make sure our GSEs—Fannie Mae, Freddie Mac, the Home Loan Banks—have strong regulators. One of the few times in my 5, 6 years on this Committee I have seen us actually break apart along partisan lines has been on this particular issue. The House has passed—they have come together overwhelmingly around a measure over there that I think most folks on our side can support. We are falling apart in two areas, and Senator Reed has done a lot of work on the affordable housing fund. My sense is that we could probably put something together there, but the bigger issue is the portfolio, restrictions on the portfolio and composition of the portfolios.

If you could each just briefly share with us some comments, some guidance, some counsel on how we might bridge our differences with respect to particularly the portfolio issues on GSE reform, I would appreciate that.

Mr. STEVENS. Well, certainly the Association is in favor of oversight and—you know, regulatory oversight. I think the difference in the portfolio, I think it becomes restrictive. You know, our position has been that we do not think that should be there. There should be portfolio restriction, but it should be left up to the regulator. If you are going to put someone in charge with guidance and restrictive capabilities, then that should be left up to that regulator. It should not be an artificially imposed number.

Senator CARPER. Good.

Mr. Seiders.

Mr. SEIDERS. From my economist's point of view, my concern on the GSE front would be what the reform package could do to the spread between the home mortgage rate and, say, a comparable maturity Treasury like the 10-year Treasury yield. In my forecast, I have got that spread dead-steady about where it is right now, about 155, 160 basis points.

I just would encourage the Congress to avoid doing anything that would disrupt the markets to the degree that the mortgage rate would move up out of alignment from Treasury yields, and it is possible that rather draconian limits on the GSE's portfolios, or even requiring some liquidation, could affect that spread. That is my key concern.

Senator CARPER. Good. Thank you, sir.

Mr. Brown.

Mr. BROWN. I do not think we have anything to add on that.

Senator CARPER. Mr. Lawler, any comment?

Mr. LAWLER. Yes. OFHEO strongly supports legislation and hopes that a compromise will be achieved. We believe that the portfolios are larger than they need to be and that guidance from Congress would be very desirable. The Senate language in the Senate bill appears very restrictive in some areas and may not—it could be interpreted to restrict the ability of the enterprises to function in a crisis situation, for example, or to have all of the appropriate—to be able to invest in all of the kinds of affordable housing loans that are appropriate for their mission.

Senator CARPER. My thanks to each of you for those responses. Thank you.

Thank you, Mr. Chairman.

Senator BUNNING. Senator Sarbanes.

Senator SARBANES. Well, thank you very much, Senator Bunning.

I want to commend Senator Bunning and Senator Allard for joining the two subcommittees together in order to hold these hearings. I think it is a very constructive approach, and I know we will be doing a second hearing next week on some of these exotic mortgage products. I actually wanted to anticipate that a little bit.

Mr. Brown, in his testimony—actually, in a footnote to his testimony—cites data saying that 43 percent of first-time homebuyers in 2005 obtained 100 percent financing. In other words, they had no down payment, almost half of all homebuyers. He cites as his source actually a National Association of Realtors profile of homebuyers and sellers.

My first question is: Are these homes concentrated in areas where prices appreciated the most?

Mr. BROWN. I do not believe that we have that information, but I will say that the extent of 100 percent financing really speaks to the second mortgage situation. Typically, most first mortgages are still for 80 percent or 90 percent financing. But whereas a borrower would have had mortgage insurance before, now they may have a second mortgage that stands in place of the down payment.

That is a change in mortgage practices that has helped to bring in new homebuyers. It is something that at the margin has helped to keep demand going during the latter stages of the housing boom.

Senator SARBANES. Well, if this is more concentrated in areas that are likely to experience house price decreases, what outcome would we then expect for these homeowners? Are we facing the potential of sort of a major crisis of defaults and foreclosures?

Mr. BROWN. Well, once again, I do not have specific information that it is more prevalent in those markets than in other markets around the country. Certainly incomes tend to be higher in some of the boom markets with more vibrant economies, so it is not clear at the outset that that is the case.

However, the research that the FDIC did looking at the prevalence of large declines in home prices speaks to exactly the issue that you are bringing up: How likely is it that a large downward home price decline will wipe out a significant portion of equity or all of the equity for a substantial portion of homebuyers? That is a credit event with regard to lenders and certainly for FDIC-insured institutions, affecting not only mortgage portfolios but also construction portfolios. In the problems of the 1980's and early 1990's that the FDIC experienced, those sorts of busts certainly did have big credit problems associated with them.

Senator SARBANES. Does anyone else want to add to that?

Mr. STEVENS. The National Association of Realtors, we do not have those numbers where those first-time buyers specifically are buying. But, anecdotally, we have found that a lot of it is concentrated in those resort areas, which you have a big resort area in Maryland, Ocean City, et cetera. But that is basically it.

Those products are phenomenal products to get first-time buyers into homes. The challenge is you have to make sure they are applied and administered properly. That is where you end up with your default rates raising and foreclosure rates.

Senator SARBANES. Right. Mr. Seiders.

Mr. SEIDERS. Well, just to add, that in what had been the hottest markets, obviously the price appreciation was very, very rapid. It obviously depends on when the person got the loan. There might be a lot of equity already under their belt and they could absorb, or most of them absorb, at least a modest decline in house values before they would be thinking of default.

We also know that there seems to be a fairly strong correlation between the prevalence of that kind of exotic financing structure and the prevalence of investor buying. I am thinking now of the kinds of investors that are not in it for the long haul but for the short haul, for price appreciation.

If that is the case, I would expect those investors to be hanging on or getting out without serious damage to themselves as consumers. So we will see how it winds out. I mentioned earlier it is one of the downside risks to my forecast as to how this will all pan out.

Senator SARBANES. Yes. Of course, I have a concern, you know, we are not facing a modest decline. I know that OFHEO put out a release showing that the housing price index shows the largest deceleration in three decades. It is still going up, but just in the last quarter, hardly at all, as I understand it.

I gather that some economists are predicting, actually, that there is going to be a decline in nominal house values. So, you know, we may be facing and approaching a crisis situation, and it underscores, to me at least, what I regard as the—well, I do not want to use the word "fragility" of the housing finance system, but it is a sensitive structure. It has worked very well. We have put a lot of people into homeownership. In many respects it is very complicated.

You all are very much involved in making it work, but there are two things on the agenda that concern me greatly. One is this increase in interest rates, which Senator Bunning was referring to. I have been for some time now urging the Fed to stop this process, which they have now done, although they had some dissent on that within the Open Market Committee—at least one open dissent—actually, the head of my regional Fed Board, who continues to run around making speeches about this. But the impact of that can be quite severe.

The other we touched on, as Senator Carper, on the question of GSEs. Actually, there is no difference within this Committee about setting up a strong regulator. Both proposals, both from the majority and the minority, had put significant powers into the regulator, comparable to what the bank regulators have. We differed—well, there is not an affordable housing provision there, and that is a concern, and then the portfolio restrictions.

We have heard from the low-income tax credit people, the mortgage revenue bond people, the multifamily housing people, all of whom try to provide affordable housing, that those portfolio restrictions would, in effect, put them out of business. They are fearful that that would be the case. And, you know, I am happy to give the regulators safety and soundness authorities over the portfolio, but I am quite concerned about going beyond that because I think it could upset this financing mechanism that we have established. So I think we need to be extremely careful about that.

I wanted to just close—I see my time has expired—by asking Mr. Seiders for the homebuilders and Mr. Stevens for the realtors: Do you feel that your voice is heard at the Fed on some of these complicated issues, that you have a reasonable opportunity to present your concerns and to have them listened to? And how does that take place? And what could be done to strengthen it? And then, more broadly, I would say to all that the Managing Director for Real Estate Finance at Moody's say, and I quote him, "The soft landing is sort of like the white whale—much rumored, rarely seen." And I am sort of interested in what the members of the panel see in terms of the possibilities of achieving a soft landing. If you could address those two very quickly, I would appreciate it.

Thank you, Mr. Chairman.

Mr. SEIDERS. On the second question first, in terms of the soft landing possibilities, I think there are some precedents in history for a housing setback that did not go really deep. The one that comes immediately to mind is the 1994–1995 period. The Fed was tightening aggressively during 1994, into early 2005. Housing really did start to lose ground rapidly. In fact, Chairman Greenspan came and spoke to our board of directors that January, kind of into the lion's den, but the Fed then subsequently eased off later in 1995. The whole thing, after a downshift went ahead fine.

It is a different environment this time in terms of what has caused this boom-bust and so forth, and my forecast does have—I guess you would call it a relatively soft landing, although I've got housing starts down about 11 percent in both 2006 and then again in 2007. So it is a real downslide for sure. If you want to call that soft, that is in the eye of the beholder. To me it is a bit alarming.

In terms of our communication with the Federal Reserve, I think it has been good over the years. We routinely have meetings with the Fed Chairman or maybe even other members of the Federal Reserve Board. Sometimes our own officers will take in the CEO's of the very big building companies. We also take in CEOs from the big suppliers to our industry that come and supply the materials and so forth.

We actually have, since some time back with Chairman Greenspan, done some special surveying of builders that we share with the Fed, and we share all of our ongoing survey information with them, even if it is confidential for other reasons. And Chairman Bernanke seems very, very receptive to receiving our information and discussing it with us. We had a meeting with Chairman Bernanke about 10 days ago, I guess, within the last 2 weeks, and we expect to be able to do that periodically.

Senator SARBANES. Do you talk to the members of the Open Market Committee? They meet as a committee and they vote, you know. Do you have a chance to make these presentations to the broader membership?

Mr. SEIDERS. The last meeting that we had with the Federal Reserve, there were five Federal Reserve Board Governors present. That is a fairly good sized piece of the FOMC.

There is some contact with some of the Federal Reserve Bank presidents who are on the FOMC about what is happening in the housing sector. That I think could definitely be strengthened.

Senator SARBANES. Yes.

Mr. Stevens, do you want to add to that?

Mr. STEVENS. Very similar. We have pretty much been granted an open door. We have a meeting with the Fed Chair and the presidents twice a year.

Senator SARBANES. The presidents of the regional banks?

Mr. STEVENS. Yes. And the Fed Chair has—we send our reports and our studies to him on a regular basis for their analysis and use as they see fit. So we feel like there has been an open-door policy. And we would have liked them to have listened a little sooner on the increase in the rates. As I said earlier, we think it is real temperamental right now. You know, our chief economist's studies show that if they were to raise rates another half percent, you know, all appreciation disappears. It stops. If we go another percent, then we are in about a 2.5 to 3 percent reverse in appreciation. House values decline.

So we are still sitting there on the fence to see if it was stopped in time or not. I think by the end of the year will tell.

Senator SARBANES. Thank you, Mr. Chairman. Can I just close with this observation? You know, these members of the Open Market Committee, they all have a vote, each one of them, and it seems to me that—I appreciate your suggestion that you should maybe deal with them directly and not necessarily put the Chairman of the Fed in the position of having to transmit it through and be the persuading agent instead of them hearing very directly from those that are actually in the field and having the experience as to what the problems are.

Mr. LAWLER. I wonder if I could respond briefly to the Senator's second——

Senator BUNNING. Well, he has gone, let us see, about 10 minutes over, so I am going to cut him off. And I just want to say that Chairman Bernanke has made it very clear that he would like to diffuse the influence of the Fed Chair and have the regional bank presidents have more to say about Fed policy.

Now, that is what he said. Let's see what he does.

Senator SARBANES. Well, if that happens, even more under——

Senator BUNNING. Even more.

Senator SARBANES [continuing]. What we were just discussing.

Senator BUNNING. All right. Senator Allard.

Senator ALLARD. Thank you, Chairman Bunning.

I want to explore a little bit these local markets. You know, I think a couple of you mentioned the impact of local markets, and it is difficult to look at it from a national perspective when you look at housing bust and boom cycles, as Mr. Brown referred to, because so many times it depends on, if you have a one-company town, how well that company is doing, or maybe there are other factors in there that are driving these local markets.

I think Alan Greenspan in some testimony we had before the Committee at one time, you know, because of local markets bubbling up and down, he called it a "froth" nationwide. And his kind of approach was that it had more local significance sometimes than it does national significance.

The Wall Street Journal in 2005 tried to kind of nationalize the argument a little bit by saying that 22 of the metro areas with the fastest-growing price growth had more than 35 percent of the Nation's housing wealth. I guess the thought that came to my mind—and I would like to hear a comment on this, and I do not know as I have seen studies of this, but I suspect that probably family income in urban areas rose much faster in urban areas than it did in rural areas also.

But I guess the fundamental question here is: Do these possible local issues actually have some national implications? I will open that up for discussion from the entire panel.

Mr. BROWN. Senator, let me start on that. Yes, certainly, the scope of the housing boom with 89 markets, including some very big markets such as San Francisco, Los Angeles, Washington, D.C., and New York, containing a large proportion of the value of U.S. real estate, leads to some concerns about what happens if they slow at nearly the same time and what effect is that going to have on construction and household wealth. So I do think that the scope does cause some concerns. It is unprecedented. It is one of the wild cards in this situation compared to our previous experience.

Senator ALLARD. Any other comments on that?

Mr. SEIDERS. I certainly agree with your premise. We talk about housing markets being localized largely because you cannot move inventory around, you know, either in or out. But people can move in and out, and, you know, very bad economic or housing market conditions in major metro areas do have their way of making their way around a bit. And if you do add up the areas that were clearly overheated, at least in price terms, you have got a big chunk of the national market.

Mr. LAWLER. I think that while it is true that there have been very different rates of growth in different parts of the country, the changes in growth rates have been somewhat across the board. Recently, the deceleration that we have seen has occurred everywhere. The biggest drops in growth rates have been in the areas that have been growing the fastest, but areas with actual decreases that we saw in the second quarter were areas that had been growing very slowly, prices had been increasing very slowly before, and where the economies are not as strong as some other areas.

Senator ALLARD. OK. Let me pursue the cost of owning homes compared to renting a home nationwide. How does this compare on a nationwide basis, particularly in those markets experiencing the most significant housing price increases? And, also, maybe comment a little bit on how this compares to historical trends.

Mr. LAWLER. Well, we have seen prices greatly outpace rent growth over the past 5 years, and that has started to change, especially in the condo areas. The rapid growth of prices for single-family houses resulted in a lot of switches from rental units to condos, brought on a lot of new supply, to the point where those markets have looked suddenly among the very weakest. But taking those out of the rental markets stimulates rent a little bit, and these things tend to equalize over time.

Mr. SEIDERS. The tremendous surge in buying activity drove the Nation's homeownership rate and the rental vacancy rate to record highs at the same time in the early part of 2004. And the cost of owning in terms of monthly payment compared to rent was climbing dramatically during that period.

One reason it could continue with momentum on the home-buying side was that, in terms of what people consider the cost of owning a home to be, it includes expected price appreciation, and all the price appreciation going on fostered expectations of further price appreciation. So it felt like a really good deal, even cost of living-wise in a sense, to be buying rather than renting.

We have really seen that swing now, and in the multifamily housing sector, there now is a rather significant downslide in the condo component. You know, that is going down. There is now upward pressure on rents and renewed interest in building for the rental market. Actually, in my forecast I have the production of rental housing moving up to some degree later this year and in 2007 as the homeownership side comes down, including the condo component.

Senator ALLARD. Interesting.

Thank you, Mr. Chairman.

Senator BUNNING. Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Mr. Brown, following up the line of questioning I concluded with Mr. Seiders, the suggestion I think that Mr. Seiders had is that it is hard to sometimes realize what types of mortgage instrument a borrower has out there. It could be a no-interest loan. It could be—you know, I do not even understand all the different products out there.

But, going to the FDIC, do you have a notion of how many people are having these exotic loans? And are there multiple exotic loans? And do you feel confident that you understand actually the situation? I do not say that, you know, critically, just factually. Do you have a sense you understand what is going on?

Mr. BROWN. Yes, our analysts make use of state-of-the-art data from companies like Loan Performance and obviously from the Mortgage Bankers Association and other good sources. Some of the studies that these groups have put together, for example, one study by First American Mortgage Solutions, which is now affiliated with Loan Performance, estimates that about 22 percent of all outstanding U.S. mortgages are adjustable rate mortgages that were made in 2004 and 2005.

If you couple that with the estimates made using the Loan Performance database by both Loan Performance and by our analysts, perhaps 40 to 50 percent of those adjustable rate loans during 2004 and 2005 were the interest-only and payment option variety. So you are really talking in the neighborhood of 10 percent of the U.S. mortgage book. Of that 10 percent, then, some are taken out by high-net-worth individuals that have irregular incomes and want to use it for wealth management. Perhaps other households avail themselves of those loans as affordability products to try to afford high-priced homes in some of these boom markets.

This gives us an order of magnitude in terms of the scope of those markets. Yes, they have really proliferated in recent years. That is a new thing. And it is uncertain as to how they will perform as interest rates rise and as the low introductory rates expire. But I think we have an overall viewpoint as to the order of magnitude of those loans.

Senator REED. So your sense is that this potential for significant foreclosures because of these types of lending arrangements is not decisive?

Mr. BROWN. Well, here is the situation. I think that we certainly could see some increases in credit problems among those borrowers who use those affordability products and who, when the introductory rates expire, will have problems repaying those loans. I think you are going to see credit distress among those households. There is no question.

At the same time, we have to recognize that those loans have been largely securitized in private asset-backed securities and sold to investors around the world. I think the consensus of mortgage professionals and economists is that those risks have been spread around in a fairly efficient manner. But certainly I think the impact on those individuals who are caught in that situation, if they really cannot afford the payments as they go up, will be serious.

Senator REED. Absolutely.

Mr. Lawler, you might want to comment now. You had a comment previously for Senator Sarbanes. But you might also touch upon this issue of the data that you are seeing, does it give you confidence that you have a reasonable grasp of what the situation would be with particularly these exotic products?

Mr. LAWLER. OK. I wanted to say, with respect to the effect of legislation on the markets, that it is important to keep in mind that only about 30 percent of the assets in the enterprises' retained portfolios help meet their affordable housing goals. Those are important assets, and I think what is key in legislation is for Congress to give some direction to the regulator about what assets really are the most important for the enterprises to hold and what are of less importance, what can reasonably be cut back and what might have damaging consequences for affordable housing if it were cut back, so the regulator would have some guidance in that area.

On these exotic loans, I think one of the concerns is that a lot of the loans were made to people who can afford the higher rates. They were underwritten appropriately and the borrowers can afford them, in many cases as investors who found this a very convenient and inexpensive way to maximize the leverage that they were getting on new properties.

But the risk there is that when rates that they are actually having to pay go up monthly and start to exceed the income that is coming in, if they are renting them out, they may be reluctant to hold onto them and may be more willing to try and sell them, which could put downward pressure on prices.

Senator REED. Any other comments? Mr. Stevens, please.

Mr. STEVENS. Just in the package that I submitted for the record, there are some charts in there showing the markets that carry higher risk due to the adjustable rate mortgages and things.

Senator REED. Thank you very much.

Mr. SEIDERS. Maybe one final comment. One of the things that I am counting on with a lot of these strange mortgages coming home to roost in terms of big payment adjustments is the ability of the homeowner to refinance into something else. And my understanding is that most of these do not have hefty prepayment penalties in them. Some of the people in the mortgage finance industry are looking for a mini-refi boom as a lot of these mortgages approach their first payment reset. Some of that is already happening.

Senator REED. Thank you.

Thank you, Mr. Chairman.

Senator BUNNING. A couple more. This question is for anyone who would like to—it is a toss-up. Do you think that price increases and sales volumes in the last 3 years were driven by normal market conditions? Or was it something unsustainable? Was there an unsustainable factor in the housing boom?

Mr. BROWN. I would like to start with that. I do believe that booms historically are situations where prices do get out ahead of the fundamentals. To that extent, the booms have never proven to last forever, and by definition, they are unsustainable.

What really matters, I think, is the aftermath. In two-thirds of the cases, after we have seen these booms, the prices fell in at least 1 year of the next 5. We only found, however, nine cases where they fell as far as 15 percent over the next 5 years. So I think this period of stagnation, which can be fairly painful for homeowners and homebuilders, is the most common outcome. And if that is the definition of unsustainable, yes, I think booms are inherently unsustainable.

Mr. LAWLER. I agree that there are some unsustainable features. One of them clearly were the rates of increase in prices that were far outstripping growth in incomes. That could not be maintained indefinitely.

And in the past, at least on an inflation-adjusted basis, we have seen cycles in many, many cities across the country, and also even in the national data. As real changes in demand occur, it is difficult for supply to keep pace, especially in some areas with more supply restrictions than others, more congestion, or more restrictions on zoning, for example. And so that can create cyclical behavior, and we have seen it on an inflation-adjusted basis for the country as a whole several times now.

Senator BUNNING. This question would be for Mr. Brown and Mr. Lawler. What, if any, impact has the housing boom had on consumer spending? In particular, is there reliable evidence that consumers have tapped wealth from home value increases to spend on home improvements, durable goods, or other things?

Mr. LAWLER. Well, I think definitely we are seeing substantial volumes of refinancing over the past year—even as interest rates have increased by a full percentage point—long-term interest rates over a full percentage points over the last year, and short-term rates more than that.

The main reason for this refinancing is to take cash out. We have seen some increases in spending on renovations, but most of it is going elsewhere, either to pay off debt or to buy consumption items.

Mr. BROWN. Adding cash-out refinancings and the increase in home equity lines of credit outstanding, totals approximately $450 billion in 2005. That is around 4 percent of disposable income. That is a pretty big number in terms of spendable cash.

Now, some of that money is going back into homes. It is not purely consumption outside the home. And, again, this is in many cases part of an overall wealth management strategy by households that may have other assets offsetting their mortgage debt. The extent to which households decide to do extra spending based on the fact that they can borrow against their home, is not necessarily shown by the volume of cash-out refinancing and home equity lines.

Mr. SEIDERS. Chairman Bunning, I was going to say on that, there is little doubt that, the housing wealth effect had a strong impact supporting consumer spending in the last couple of years. It really is a factor that has allowed the personal saving rate to go negative, for as long as it has.

Also, in my view, it is really the housing wealth effect that matters the most, not how it is, in a sense, accessed. It does not have to be accessed through mortgage borrowing. You can spend all of your income. You can use financial assets. You can use other kinds of borrowing and so forth.

So it is one of these big things in the economy that is definitely in the process of weakening in terms of support to the consumer sector.

Senator BUNNING. Well, if you all have good memories, Chairman Greenspan popped the bubble in 2001 and 2002 on the tech rally, and he always complained about the wealth component, and he took care of that in about a year and a half. [Laughter.]

Senator BUNNING. So I hope that is not the case for the housing situation.

We are going to leave the record open for 10 days so anyone on the Subcommittee can submit a question, if they would like, to anyone here on the panel.

I want to thank everyone for attending the joint hearing of the Housing and Transportation Subcommittee and the Economic Policy Subcommittee, and the hearing is adjourned. Thank you.

[Whereupon, at 11:37 a.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF PATRICK LAWLER

CHIEF ECONOMIST, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

SEPTEMBER 13, 2006

I am pleased to be here, where I worked as a Committee staff member some years ago, to testify on housing market developments and prospects. The Office of Federal Housing Enterprise Oversight, OFHEO, has a strong interest in housing markets and particularly in house prices because they have a powerful effect on the credit quality of mortgage loans owned or guaranteed by Fannie Mae and Freddie Mac, the Enterprises we regulate.

Over the past five years, we have witnessed an extraordinary change in the relative price of houses. The general level of house prices soared 56 percent from the spring of 2001 to the spring of 2006. The prices of other goods and services rose much less, so that inflation-adjusted house prices are now 38 percent higher than 5 years ago. That exceeds the inflation-adjusted increase in the previous 26 years, going back to the beginning of OFHEO's data.

A number of factors have contributed to these price gains. Long-term mortgage interest rates fell from about 8 percent in mid-2000 to generally less than 6 percent in the period from early 2003 to mid-2005. Short-term rates declined by more, and borrowers took advantage, as more of them took out adjustable-rate loans. Interest-only and negative amortization loans provided even lower monthly payments. The spread of these products helped stimulate demand, as did the rapid growth of subprime lending. In 2001, less than 10 percent of new mortgage securities were backed by subprime loans. In each of the past two years, subprime lending has amounted to more than 20 percent of that market.

Demographics have also been favorable. Aging boomers are reaching their peak earning and investing years, with many interested in second homes for vacations or future retirement, and immigration has accelerated household formation. Supply constraints have made it difficult to meet the increased demand. Land use restrictions, environmental and economic impact studies, natural barriers, and existing high densities in some areas have lengthened the time necessary for builders to bring new houses on the market and raised the premiums paid for prime house locations.

Finally, there is some evidence of speculation, as the share of loans made to investors has risen and turnover rates have been high, with anecdotes of property flipping becoming common. Certainly, the poor performance of the stock market early in this decade made an obvious contrast with the investment performance of houses, and that may have encouraged some to shift their investment focus.

House price increases have been uneven across the nation, though. While homeowners in Indiana, Ohio, and Michigan have seen their house values over the past 5 years hardly budge in constant dollars, residents of Florida, California, and here in the District of Columbia have watched prices virtually double, even after adjusting for inflation. The coastal areas have generally had more vibrant economies, more in-migration, and more supply constraints.

Over the past year, the pace of house price inflation over most of the country has moderated dramatically. The sharpest decelerations have come in some of the most superheated markets of a year ago, including Arizona, Nevada, California, and Hawaii in the West and DC, Delaware, Maryland, and Virginia in this area. Nationally, prices rose roughly 1.2 percent in the second quarter of this year, a rate that only slightly exceeds the inflation rate for other goods and services in the economy. For comparison, the appreciation rate in the second quarter of last year was approximately 3.6 percent.

Housing markets in New England and the Midwest are showing some of the most significant regional weakness. The relatively anemic New England market has been cooling for the last two years. While Massachusetts, New Hampshire, and Maine saw some of the largest gains in the nation in the late 1990s and early 2000s, rates of price increase have dropped sharply since. Our latest data suggest that prices in those states were virtually unchanged in the second quarter of this year.

Although appreciation rates in the Midwest were only slightly above baseline inflation levels throughout the latest boom, the rates have declined somewhat. Price performance in Indiana, Ohio, and Michigan, in particular, appears weak. Appreciation over the last year was less than three percent in all three states, and, in the latest quarter, prices actually declined.

We are seeing continued price strength in select areas of the country. The areas affected by Hurricane Katrina, for example, have shown strong increases, presumably a result of the loss of housing stock. Prices in Louisiana, for example, rose nearly 12.5 percent between the second quarter of 2005 and the second quarter of

2006. Price appreciation in the second quarter of this year was more than double the national rate in that state. Over the past year, gains in several Katrina-affected cities, including Gulfport-Biloxi and Mobile, were between 15 and 18 percent, the largest one-year increases we have ever recorded for these cities.

Select areas in Texas, as well as parts of the Pacific Northwest, also seem to have fared relatively well. At more than 3.6 percent, quarterly appreciation rates in Oregon, Idaho, and Washington state were more than three times the national average. Appreciation in oil-rich Texas areas like Odessa and Midland also appears to have been strong.

Other market indicators confirm the general chilling of housing markets across the nation. Particularly noteworthy is the swelling inventory of unsold houses on the market, which has risen to 4.5 million from levels generally below 3 million in 2003 and 2004. As sales rates have fallen at the same time, inventories are now more than 7 times monthly sales, the highest since the early 1990s.

Historical patterns of price behavior in housing markets may provide some guidance about potential future developments. OFHEO's national House Price Index has never fallen over a period of a year or more, but it has come very close, and inflation-adjusted prices have fallen significantly, by 11 percent in the early 1980s and by 9 percent in the early 1990s. In the first instance, it took nearly 8 years for inflation-adjusted prices to regain the past peak and in the second case, almost 10 years. Certainly, a similar event is quite possible now.

Cycles in inflation-adjusted home prices have occurred in a much more pronounced way in some cities, such as Boston and Los Angeles. The cycles stem from the effects of local business cycles, the delays in the response of supply to increased prices, and to some extent from speculation. Over much of the country, fundamental factors have pushed up demand and accounted for at least a large portion of the price increases in recent years. However, increasing supply, higher interest rates, and a turn in investor-market psychology may cause prices in some markets to fall. In the past, significant nominal price declines generally have been associated with local or regional economic recession, but the exceptional size of some of the recent increases could make them vulnerable without a recession, especially if interest rates continue to rise.

In the long run, I expect housing markets to perform well, especially if immigration continues at recent rates. An important caveat, though, is that healthy housing markets could soften seriously from an unexpected disruption in the ability of Fannie Mae and Freddie Mac to function effectively in secondary mortgage markets. OFHEO is currently focused on correcting the significant accounting, internal control, management, and corporate governance weaknesses identified at both companies through OFHEO examinations. While both companies have made progress, much more needs to be done. It is apparent that in order to ensure the long-run safety of these two GSEs, the regulatory framework must also be strengthened. OFHEO supports the enactment this year of legislation, currently before the full Committee, that will create a new regulator with adequate funding, bank-like regulatory and enforcement authorities and encompassing not only safety and soundness, but also mission regulation.

Research and OFHEO's House Price Index

I now would like to talk briefly about some of OFHEO's research activities related to measuring home price trends. OFHEO's work has been focused on our House Price Index (HPI), which we publish quarterly. We estimate quarterly price changes for single-family houses at the national level and for census divisions, states, and metropolitan statistical areas. We use data obtained from Fannie Mae and Freddie Mac on values of houses in repeat mortgage transactions.

OFHEO is working hard to ensure that our house price index remains an accurate and reliable indicator for both internal and external use. Precise measurement of historical price movements is extremely important in measuring the credit exposure at Fannie Mae and Freddie Mac, a critical part of OFHEO's regulatory duty. It is also important because mismeasurement may obscure indications of any accelerations or reversals in the housing cycle. Such information is valuable not just to OFHEO, but also to the other disparate entities and individuals that use our data. Government and private policy analysts, risk modelers at Wall Street firms, and even individual homeowners interested in tracking their home values all employ our data. Our historical index data, as well as related market commentary, are all available on OFHEO's website.

Accurately measuring house price movements is quite challenging. One of the fundamental difficulties stems from the fact that houses do not sell frequently. At best, sporadic measurements of home values are usually available. Also, homes obviously differ substantially in their size and quality. This heterogeneity means that the average sales price of properties reflects not only trends in house prices, but also changes in the mix of houses transacting.

A final challenge is that home valuation measures are not always perfect indicators of true home values. For example, much of OFHEO's home value information is derived from appraisals produced in the home refinancing process. Such appraisals, for a variety of reasons, may not always accurately reflect true home values.

OFHEO in fact is actively researching the issue of appraisal bias. The underlying research question to be addressed is: "How can appraisal bias be stripped from the OFHEO index without having to remove all appraisal data from OFHEO's calculations?" Although home price appraisals may systematically differ from purchase price information, their inclusion can provide valuable information about price trends, particularly for small cities where the availability of price data is at a premium. More fundamentally, to the extent that refinanced homes may have different attributes than other homes, the inclusion of refinance-related appraisals provides our models with a potentially broader sampling of appreciation patterns.

Preliminary research suggests that a refined methodology that aims to remove appraisal bias from the HPI may reflect long-run historical price patterns that are quite similar to what has been observed in the usual HPI. Despite the similarity, however, OFHEO may pursue such a refinement because changes in the mix of refinance and purchase valuations can affect measured short-term price change patterns.

Another issue of broad research and policy significance is the effect of home improvements on measured price trends. Some observers have wondered whether a significant share of the dramatic appreciation reflected in the OFHEO HPI has been caused by home remodeling activity as opposed to fundamental price increases. The concern has been motivated in part by a divergence between appreciation shown in the OFHEO index and house price growth reflected in a "constant-quality" index produced by the Census Bureau.

Although the OFHEO index is generically classified as a constant-quality index, some recent appreciation may indeed reflect net quality improvements in the housing stock. Outside research coupled with as-yet unpublished internal OFHEO work nevertheless suggests that, even under generous assumptions concerning the impact of remodeling on home valuations, a relatively modest amount of appreciation is accounted for by what might be described as "quality drift." In short, the recent price run-ups are not mere illusions caused by the fact that Americans are buying bigger and better homes.

While OFHEO does not publish home price forecasts, it maintains a strong interest in available information concerning future expectations. One potentially useful development in this area is the introduction of real estate futures exchanges. Such exchanges, at least in theory, may one day provide a meaningful summary of the market's best guess for the future price trends. Unfortunately, trading volumes on these nascent futures exchanges are relatively low. Thus, although some futures markets currently point to small home price declines through the Spring of 2007, the implied price trajectories may not reliably reflect aggregate expectations concerning future prices.

Conclusion

Although the future direction of home prices is the subject of great speculation, there is little doubt that several factors may constrain appreciation rates in the near future. First and most fundamentally, home prices are at historically high levels and have already started to stretch past many traditional affordability boundaries. Home affordability is at very low levels in places like California and the New England states, for example. Barring very significant increases in average incomes or interest rate declines, these price levels will weigh heavily against major price increases in the near term.

The second constraint on appreciation rates is rising housing inventories. The number of homes available for sale has increased substantially over the last year, giving homebuyers much more bargaining power than they have had in recent periods. Such bargaining power can lead sellers to reduce prices.

The third and final factor involves market psychology. Although it has been difficult to accurately quantify the effect of speculative activity on recent appreciation patterns, anecdotal evidence suggests that its effect may have been material in select markets in California, Nevada, Arizona, and other states. To the extent that the recent slowdown in appreciation rates may sour some potential investors on real estate investments, home demand may decline somewhat.

Despite the presence of various factors that may act to constrain price appreciation in the near term, I would like to stress that housing markets and price appreciation are affected by some very basic economic and demographic patterns. For example, migration patterns (both domestic and international) affect the demand for housing and thus influence price movements. Also, the extent to which retiring baby boomers opt to increase or decrease their demand for second homes may also play a role in determining the direction of prices in the future. Finally, the cost of constructing new homes clearly can play a role in affecting supply and thus home prices. As is the case in other markets, the future trajectory of prices will be determined through a netting out of these factors, in addition to the short-term demand and supply determinants that have already been discussed. Thank you, and I'd be happy to answer any questions.

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FOR IMMEDIATE RELEASE
September 5, 2006

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HOUSE PRICE APPRECIATION SLOWS

OFHEO HOUSE PRICE INDEX SHOWS LARGEST DECELERATION IN THREE DECADES

WASHINGTON, D.C.—U.S. home prices continued to rise in the second quarter of this year but the rate of increase fell sharply. Home prices were 10.06 percent higher in the second quarter of 2006 than they were one year earlier. Appreciation for the most recent quarter was 1.17 percent, or an annualized rate of 4.68 percent. The quarterly rate reflects a sharp decline of more than one percentage point from the previous quarter and is the lowest rate of appreciation since the fourth quarter of 1999. The decline in the quarterly rate over the past year is the sharpest since the beginning of OFHEO's House Price Index (HPI) in 1975. The figures were released today by OFHEO Director James B. Lockhart, as part of the HPI, a quarterly report analyzing housing price appreciation trends.

"These data are a strong indication that the housing market is cooling in a very significant way," said Lockhart. "Indeed, the deceleration appears in almost every region of the country."

Possible causes of the decrease in appreciation rates include higher interest rates, a drop in speculative activity, and rising inventories of homes. "The very high appreciation rates we've seen in recent years spurred increased construction," said OFHEO Chief Economist Patrick Lawler. "That coupled with slower sales has led to higher inventories and these inventories will continue to constrain future appreciation rates," Lawler said.

House prices grew faster over the past year than did prices of non-housing goods and services reflected in the Consumer Price Index. While house prices rose 10.06 percent, prices of other goods and services rose only 4.41 percent. The pace of house price appreciation in the most recent quarter more closely resembles the non-housing inflation rate.

Significant findings in the HPI:

1. All states show four-quarter appreciation, but five Midwestern and New England states had small price decreases in the second quarter.
2. Price appreciation remains relatively robust in the two states hardest hit by Hurricane Katrina one year ago—Louisiana and Mississippi. Four-quarter appreciation rates were well above the national average in several cities in the area including: New Orleans-Metairie-Kenner, Gulfport-Biloxi, Baton Rouge, and Pascagoula. Gulfport-Biloxi and Pascagoula in fact logged their highest appreciation rates since the beginning of OFHEO's Index.
3. The South Atlantic Census Division including Florida, Delaware, the District of Columbia, Virginia and Maryland experienced its most significant price deceleration since at least the early 1980s. Its four-quarter appreciation rate fell from 17.43 percent to 13.74 percent.
4. New England's four-quarter appreciation rate fell from 8.71 percent to 5.68 percent. While appreciation rates in Massachusetts were consistently amid

the 10 highest between mid–1997 and mid–2003, its four-quarter appreciation rate now ranks 48th among the states and the District of Columbia.
5. Despite a nine percentage point decline in its four-quarter appreciation rate, Arizona's housing market still exhibits the highest appreciation rate among the 50 states. Prices were up roughly 24 percent compared to the second quarter of 2005 but grew only 2.94 percent in the most recent quarter.
6. While the 20 Metropolitan Statistical Areas (MSAs) with the highest appreciation included nine cities in Florida, the representation of other states continues to increase. MSAs in North Carolina, South Carolina, and Washington State have now entered the list of fastest appreciating markets.
7. Michigan had the greatest numbers of price decreases among ranked MSAs. Thirteen of Michigan's 16 ranked metropolitan areas exhibited quarterly price decreases.

One of the more striking elements of the new HPI data is that four-quarter appreciation rates fell sharply in four of the five states that had fastest appreciation in last quarter's HPI release. This subject is discussed in greater detail in the Highlights section of this report on page 8.

Changes in the mix of data from refinancings and house purchase transactions can affect HPI results. An index using only purchase price data indicates somewhat less price appreciation for U.S. houses between the second quarter of 2005 and the second quarter of 2006. That index increased 8.27 percent, compared with 10.06 percent for the HPI.

OFHEO's House Price Index is published on a quarterly basis and tracks average house price changes in repeat sales or refinancings of the same single-family properties. OFHEO's index is based on analysis of data obtained from Fannie Mae and Freddie Mac from more than 31 million repeat transactions over the past 31 years. OFHEO analyzes the combined mortgage records of Fannie Mae and Freddie Mac, which form the nation's largest database of conventional, conforming mortgage transactions. The conforming loan limit for mortgages purchased in 2006 is $417,000.

This HPI report contains four tables: 1) A ranking of the 50 States and Washington, D.C. by House Price Appreciation; 2) Percentage Changes in House Price Appreciation by Census Division; 3) A ranking of 275 Metropolitan Statistical Areas (MSAs) and Metropolitan Divisions by House Price Appreciation; and 4) A list of one-year and five-year House Price Appreciation rates for MSAs not ranked.

OFHEO's HPI report in PDF form is accessible at www.ofheo.gov. Also, be sure to visit www.ofheo.gov to use the OFHEO House Price calculator. The next HPI report will be posted December 1, 2006. Please e-mail ofheoinquiries@ofheo.gov for a printed copy of the report.

HOUSE PRICE APPRECIATION BY STATE—PERCENT CHANGE IN HOUSE PRICES

[Period ended June 30, 2006]

State	Rank*	1-Yr.	Qtr.	5-Yr.	Since 1980
Arizona, (AZ)	1	24.05	2.94	96.71	323.30
Florida, (FL)	2	21.28	2.51	112.59	377.53
Idaho, (ID)	3	20.14	3.78	55.27	229.24
Oregon, (OR)	4	19.47	3.99	63.79	333.68
Hawaii, (HI)	5	18.09	0.43	111.21	427.63
Washington, (WA)	6	17.39	3.67	60.21	363.59
Maryland, (MD)	7	16.21	2.31	102.68	422.09
District of Columbia, (DC)	8	15.86	1.28	119.97	534.93
New Mexico, (NM)	9	15.54	4.22	50.30	215.40
Utah, (UT)	10	15.17	3.75	33.39	229.32
California, (CA)	11	14.35	1.25	111.93	543.28
Virginia, (VA)	12	14.24	2.01	83.38	360.29
Wyoming, (WY)	13	13.97	2.94	55.61	149.60
Alaska, (AK)	14	12.90	2.82	53.01	169.33
Montana, (MT)	15	12.66	3.12	55.84	254.28
Louisiana, (LA)	16	12.48	2.71	37.92	134.09
New Jersey, (NJ)	17	12.43	1.85	84.98	475.25
Delaware, (DE)	18	11.78	0.63	70.75	392.00
Nevada, (NV)	19	11.44	0.26	104.77	312.02
Vermont, (VT)	20	11.28	2.45	65.97	350.98

HOUSE PRICE APPRECIATION BY STATE—PERCENT CHANGE IN HOUSE PRICES—Continued

[Period ended June 30, 2006]

State	Rank*	1-Yr.	Qtr.	5-Yr.	Since 1980
Pennsylvania, (PA)	21	10.69	1.61	55.57	299.17
United States **	....	10.06	1.17	56.49	298.85
New York, (NY)	22	9.89	0.90	72.76	554.65
Mississippi, (MS)	23	9.59	2.85	27.62	138.56
North Carolina, (NC)	24	9.32	1.93	28.41	221.47
South Carolina, (SC)	25	8.93	1.67	31.48	205.02
Alabama, (AL)	26	8.91	1.88	30.18	174.32
North Dakota, (ND)	27	8.88	3.00	39.64	140.99
Connecticut, (CT)	28	8.46	0.83	62.98	376.96
Tennessee, (TN)	29	8.10	1.96	28.06	191.09
Arkansas, (AR)	30	8.01	1.98	32.31	153.66
Illinois, (IL)	31	7.82	1.12	42.76	270.57
Rhode Island, (RI)	32	7.43	1.18	94.00	513.89
West Virginia, (WV)	33	7.40	0.15	34.73	127.04
Oklahoma, (OK)	34	6.50	1.78	26.75	97.79
Texas, (TX)	35	6.45	1.93	22.64	111.87
Maine, (ME)	36	6.25	−0.20	61.74	405.84
Georgia, (GA)	37	6.14	1.05	28.02	230.46
New Hampshire, (NH)	38	5.97	0.04	61.03	404.18
South Dakota, (SD)	39	5.96	2.05	31.18	175.99
Missouri, (MO)	40	5.77	0.45	33.29	196.36
Wisconsin, (WI)	41	5.58	0.31	36.00	226.57
Kentucky, (KY)	42	5.27	1.21	24.94	183.51
Minnesota, (MN)	43	4.94	0.28	46.61	271.41
Iowa, (IA)	44	4.30	1.26	23.61	146.78
Colorado, (CO)	45	4.20	0.96	23.68	263.10
Kansas, (KS)	46	4.15	1.04	24.10	138.93
Nebraska, (NE)	47	3.63	0.95	21.57	155.27
Massachusetts, (MA)	48	3.40	−0.44	56.98	631.67
Indiana, (IN)	49	2.76	−0.04	17.00	154.65
Ohio, (OH)	50	2.14	−0.05	18.40	172.34
Michigan, (MI)	51	1.01	−0.72	18.95	222.11

*Note: Ranking based on one-year appreciation.
**Note: United States figures based on weighted Census Division average.

PREPARED STATEMENT OF RICHARD BROWN

CHIEF ECONOMIST, FEDERAL DEPOSIT INSURANCE CORPORATION

SEPTEMBER 13, 2006

Chairman Allard, Chairman Bunning, Senator Reed and Senator Schumer, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation concerning housing markets and their implications for the economy. Like the other panelists testifying today, the FDIC closely monitors the current conditions in U.S. housing markets.

Rather than restating the housing data available for economic analysis, my testimony will summarize some recent analysis performed by FDIC staff economists on historical boom and bust cycles in the U.S. housing markets. This analysis of almost 30 years of boom and bust cycles should complement the presentations of my fellow panelists and provide the Subcommittees with perspective on the credit risks of these cycles to banks and thrift institutions.

My testimony will address four main topics: 1) the condition of the banking industry and its role in housing finance; 2) the historical performance of real estate loan portfolios at banks and thrifts; 3) the FDIC's recent analysis of housing boom and bust cycles; and 4) the implications for the future path of U.S. home prices.

Banking Industry Condition and Role in Housing Finance

At the outset of my testimony, I would like to emphasize that FDIC-insured banks and thrift institutions continue to exhibit strong earnings, low credit losses and historically high levels of capital. The industry as a whole has posted five consecutive annual earnings records and two consecutive quarterly earnings records. As of June 30, noncurrent loans measured just 0.70 percent of total loans, the lowest such ratio in the 22 years these data have been collected.[1] At that same date, the industry's Tier 1 Risk Based Capital Ratio was 10.72%, near a historic high for this ratio. In addition, no FDIC-insured institution has failed in over two years—the longest such period in the FDIC's history.

FDIC-insured institutions are extremely active in virtually every aspect of housing finance. These institutions act as lenders for home construction and the permanent financing of both single family and multifamily homes, as loan servicers and as issuers and investors in mortgage-backed securities. These lines of business have been very important in recent years to the ability of depository institutions to generate both loan growth and fee income, and have helped support the recent high levels of earnings.

Table 1

Annual Rates of Growth in Housing-Related Assets
Held by FDIC-Insured Institutions, 2002 - June 2006

Asset Category	2002	2003	2004	2005	June 2006 /1
Housing-Related Assets					
Mortgage-Backed Securities	12.6%	7.6%	13.4%	2.3%	6.3%
1- to 4-Family Mortgages	9.6%	6.5%	14.0%	11.2%	10.5%
Home Equity Lines of Credit	39.1%	34.9%	41.8%	8.9%	4.1%
Loans Secured by Multifamily Properties	9.6%	12.3%	11.4%	11.3%	6.5%
Construction and Development (C&D) Loans	5.8%	11.2%	24.0%	33.2%	31.8%
-includes both residential and nonresidential properties					
Other Loan Categories					
Commercial and Industrial (C&I) Loans	-6.6%	-3.3%	5.1%	12.2%	11.9%
Loans Secured by Commercial Real Estate (CRE) Properties	10.2%	8.7%	10.3%	9.8%	9.7%
Consumer Loans					
Total Assets	7.2%	7.6%	11.4%	7.6%	10.0%

Source: FDIC
1/ Growth rate for June 2006 reflects percent change from a year ago.

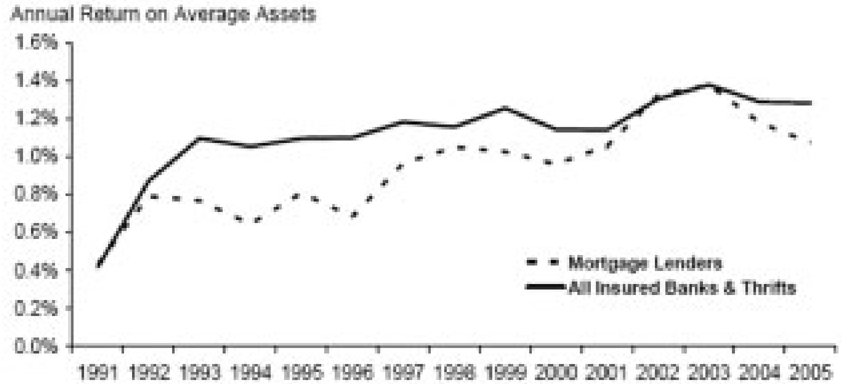
Table 1 (attached) shows that housing-related assets held by FDIC-insured institutions generally grew faster than commercial and industrial loans in the early stages of this economic expansion. In the most recent reporting period, year-over-year growth in holdings of single-family mortgages slowed slightly to 10.5 percent, but holdings of construction and development loans (which include both residential and nonresidential properties) are currently growing at an annual rate of over 30 percent.

[1] Noncurrent loans are defined as loans 90 days or more past due or in nonaccrual status.

Historical Performance of Real Estate Loan Portfolios at Banks and Thrifts

Chart 1

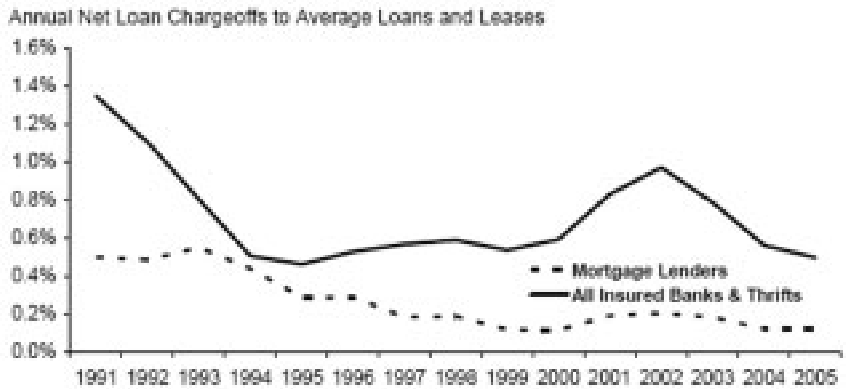
Earnings of FDIC-Insured Mortgage Lenders Have Been Steady, if Unspectacular, in Recent Years



Source: FDIC. Mortgage lenders include those institutions whose residential mortgage loans, plus mortgage-backed securities, exceed 50 percent of total assets.

Chart 2

Loan Losses of FDIC-Insured Mortgage Lenders Have Generally Remained Well Below Industry Averages

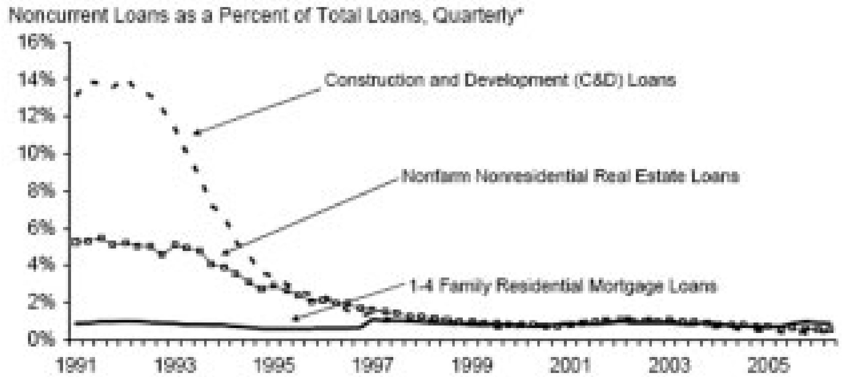


Source: FDIC. Mortgage lenders include those institutions whose residential mortgage loans, plus mortgage-backed securities, exceed 50 percent of total assets.

Across the historical period for which loan performance data are available, mortgage lending has generally proven to be a relatively low risk line of business accompanied by comparatively low returns. Charts 1 and 2 show that both the average return on assets and the average loan chargeoff rate for institutions specializing in mortgage lending have generally remained below the average for all FDIC-insured institutions over the past 15 years. This performance is not surprising because mortgage loans have traditionally been collateralized, subject to industry-standard underwriting practices and tradable in a fairly deep and liquid secondary market.

Chart 3

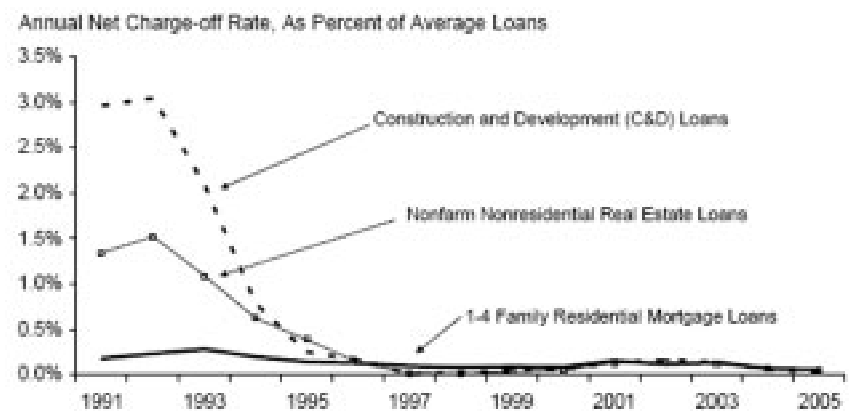
Noncurrent Rates for Home Mortgage Loans Have Stayed Far Below Rates for Other Real Estate Loans in Times of Distress



Source: FDIC. * Noncurrent loans = loans 90 days or more past due or in nonaccrual status. Data for these individual loan types began to be collected in 1991.

Chart 4

Chargeoff Rates for Home Mortgage Loans Have Stayed Below Rates for Other Real Estate Loans in Times of Distress



Source: FDIC. Data for these individual loan types began to be collected in 1991.

In contrast, the credit performance of construction and development (C&D) loans has tended to be more variable over the long-term. Specifically, Charts 3 and 4 show that C&D loans performed poorly on average during the banking and thrift crises of the late 1980s and early 1990s. During that period, speculative construction loans, both for residential and nonresidential properties, played a significant role in the failure of institutions insured by the FDIC and the FSLIC.[2] By contrast, the

[2] See FDIC, *History of the Eighties-Lessons for the Future*, Chapter 3: "Commercial Real Estate and the Banking Crises of the 1980s and early 1990s," 1997.

average overall performance of home mortgage loans remained comparatively strong during the early 1990s and has remained so up to the present time.

It also is important to note that recent ratios of both problem loans and net chargeoffs have been very low by historical standards in every loan category related to housing finance. This performance can be attributed in large part to the low interest rates of recent years, as well as the large home price increases that have been seen in many parts of the nation.

Notwithstanding the lower losses generally associated with mortgage loans over time, mortgage credit distress has been observed historically in certain metropolitan areas where severe local economic distress was accompanied by steep declines in home prices. A prime example was Houston, Texas between 1984 and 1987. As documented in the FDIC's history of the period, the shifting fortunes of the oil industry—from boom in the early 1980s to bust after 1985—was the primary force behind both a real estate bust in the latter half of that decade and the failure of hundreds of federally-insured depository institutions in the region. This boom-bust cycle represented the most serious of the regional banking crises experienced around the nation during that era.

Recent FDIC Analysis of Housing Boom and Bust Cycles

Given its historical experience, the FDIC has in recent years continuously monitored trends in U.S. home prices and mortgage lending practices as part of its risk analysis activities. FDIC analysts issued two companion studies in our FYI series in February and May 2005 that examined housing boom and bust cycles. These studies, which are summarized in my testimony and available on the FDIC's website[3], concluded that housing booms do not necessarily lead to housing busts. Instead, the analysis found that housing busts were usually associated with episodes of local economic distress.

Analytical Approach

The FDIC studies make use of the OFHEO House Price Index (HPI) series, which tracks average house prices for many U.S. metropolitan areas as far back as 1977. Based on "matched sale" observations of sale prices, and appraisals on refinancings, for the same properties over time, these data are thought to be a reliable indicator of home price trends that is relatively unaffected by changes in the composition of the housing stock.

Measuring annual changes in HPI for all metropolitan areas for which it is available, the FDIC analysts asked three simple questions:

- Where have housing booms been located?
- Where have housing busts been located?
- Does boom necessarily lead to bust in U.S. housing markets?

In order to answer these questions, the analysts first had to develop definitions of boom and bust in terms of observed price changes.

The definition of a housing boom used in the studies includes any metropolitan area that experienced at least a 30 percent increase in its HPI—adjusted for inflation—during a given three-year period. This definition serves not only to identify cities that have experienced large cumulative upward price changes in a relatively short period, but the inflation adjustment also helps to create a standard yardstick that can be used to compare price changes during periods of relatively high inflation (the late 1970s) with periods of relatively low inflation (since the early 1990s).

The analysts also created a standard definition for a metropolitan-area housing bust, namely any metropolitan area that experienced at least a 15 percent decline in HPI, in nominal terms, during a given five-year period. Nominal, as opposed to inflation-adjusted, price changes were used in the definition of a bust because it is nominal price declines that can potentially erode the equity of homeowners and reduce the incentive to repay the loan as well as the proceeds that can be obtained from the underlying collateral in the event of foreclosure. A nominal price decline of 15 percent was chosen because this represents a serious erosion of value. Such a decline would eliminate any equity of homebuyers who made only a 10 percent down payment and would seriously impair the equity of those who made a 20 per-

[3] C. Angell and N. Williams, "U.S. Home Prices: Does Bust Always Follow Boom?," FDIC, FYI, February 10, 2005, *http://www.fdic.gov/bank/analytical/fyi/2005/021005fyi.html*, and Angell and Williams, "FYI Revisited—U.S. Home Prices: Does Bust Always Follow Boom?," FDIC, FYI, May 2, 2005, *http://www.fdic.gov/bank/analytical/fyi/2005/050205fyi.html*.

cent down payment. Given the increase in high loan-to-value mortgage lending during the recent housing boom, a decline of this magnitude could cause concern.[4]

Finally, a five-year period was chosen in the definition of bust because of the observation that price declines tend to be long, drawn-out affairs rather than brief, precipitous declines. What this means is that home prices tend to be—in economist jargon—"sticky downward," with consequences described below.

Table 2

Metro-Area Housing Booms and Busts, 1978-1998, as Identified in FDIC Studies

Metropolitan Area	Boom Years	Bust Years	Bust Follows Boom?
California			
Los Angeles-Long Beach-Glendale Metro Div, CA	1978-79		
Los Angeles-Long Beach-Glendale Metro Div, CA	1988-90	1994-96	Y
Modesto, CA	1990		
Napa, CA	1990		
Oxnard-Thousand Oaks-Ventura, CA	1979		
Oxnard-Thousand Oaks-Ventura, CA	1988-90	1994-97	Y
Riverside-San Bernadino-Ontario, CA	1979		
Riverside-San Bernadino-Ontario, CA		1994-96	
Sacramento-Arden-Arcade-Roseville, CA	1979		
Sacramento-Arden-Arcade-Roseville, CA	1990		
San Diego-Carlsbad-San Marcos, CA	1979		
San Diego-Carlsbad-San Marcos, CA	1989		
San Francisco-San Mateo-Redwd Cty Metro Div, CA	1978-79		
San Francisco-San Mateo-Redwd Cty Metro Div, CA	1988-90		
San Jose-Sunnyvale-Santa Clara, CA	1978-79		
San Jose-Sunnyvale-Santa Clara, CA	1989-90		
San Luis Obispo-Paso Robles, CA	1989-90	1994-97	Y
Santa Barbara-Santa Maria-Goleta, CA	1989		
Santa Cruz-Watsonville, CA	1988-90		
Santa Rosa-Petaluma, CA	1989-90		
Other Western			
Bellingham, WA	1990-92		
Bend, OR	1990-91		
Boulder, CO	1994		
Corvallis, OR	1994-95		
Denver-Aurora, CO	1979		
Missoula, MT	1994		
Mount Vernon-Anacortes, WA	1990-91		
Ogden-Clearfield, UT	1995-96		
Provo-Orem, UT	1995-96		
Salt Lake City, UT	1994-96		
Seattle-Bellevue-Everett Metro Division, WA	1978-79		
Seattle-Bellevue-Everett Metro Division, WA	1990-91		
Oil Patch			
Anchorage, AK		1986-91	
Austin-Round Rock, TX		1989-92	
Casper, WY		1988-90	
Grand Junction, CO		1985-88	
Houston-Baytown-Sugar Land, TX		1986-90	
Lafayette, LA		1986-91	
Midland, TX		1987-92	
Odessa, TX		1989-91	
Oklahoma City, OK		1987-91	
San Antonio, TX		1988-92	

Continued on next page

[4] In 2005, 43 percent of first-time buyers obtained 100 percent financing. Source: "2005 National Association of Realtors Profile of Home Buyers and Sellers," NAR, January 2006.

Table 2

Metro-Area Housing Booms and Busts, 1978-1998, as Identified in FDIC Studies

Continued from previous page

Metropolitan Area	Boom Years	Bust Years	Bust Follows Boom?
New England			
Barnstable Town, MA	1987-88	1992-95	Y
Boston-Cambridge-Quincy Metro Division, MA	1985-88		
Bridgeport-Stamford-Norwalk, CT	1985-88		
Burlington-South Burlington, VT	1986-88		
Hartford-West Hartford-East Hartford, CT	1986-88	1993-96	Y
Manchester-Nashua, NH	1986-88	1991-96	Y
New Haven-Milford, CT	1986-88	1992-97	Y
Norwich-New London, CT	1988	1993-96	Y
Portland-South Portland-Biddeford, ME	1986-88		
Providence-New Bedford-Fall River-Warwick, RI	1985-89		
Springfield, MA	1986-88		
Worcester, MA-CT	1985-88		
Other Northeast			
Albany-Schenectady-Troy, NY	1986-88		
Allentown-Bethlehem-Easton, PA-NJ	1987-89		
New York-Northern NJ-Long Island, NY-NJ	1985-88		
Philadelphia-Camden-Wilmington, PA-NJ-DE-MD	1987-88		
Poughkeepsie-Newburgh-Middletown, NY	1986-88		
Scranton-Wilkes-Barre-Hazelton, PA	1988		
Trenton-Ewing, NJ	1986-88		
Washington-Arlington-Alexandria Metro Div, DC	1988-89		
Other Regions			
Honolulu, HI	1980		
Honolulu, HI	1989-91	1996-2001	Y
Niles-Benton Harbor, MI	1985		
Peoria, IL		1984-88	

Source: Adapted from: Cynthia Angell and Norman Williams, "U.S. Home Prices: Does Bust Always Follow Boom?" Federal Deposit Insurance Corporation, *FYI*, February 10, 2005.

Historical Results

Applying these standard definitions for booms and busts over the period from 1978 through 1998, FDIC analysts generated the list of cities that appears in Table 2. Based on these results, a few straightforward observations may be made.

1. Housing booms and housing busts, as well as other price trends that do not quite meet the FDIC's definitions, tend to be long-term trends that play out over years.
2. Despite the fact that the definition of a bust is somewhat less stringent than that of a boom, busts are observed to be relatively rare events. Prior to 2000, only 21 busts were observed compared with 54 housing booms.
3. Of the 21 metropolitan-area housing busts, only nine (43 percent) were preceded within five years by a housing boom.
4. Conversely, of the 54 observed metropolitan-area housing booms, only nine (17 percent) led to a housing bust within five years.
5. Housing booms do not last forever. Most commonly, they are followed by an extended period of "stagnation" where prices may fall, but usually not by enough to meet the FDIC's definition of a bust.

Based on these results, FDIC analysts could not conclude that boom necessarily leads to bust. Instead, they found that housing busts were usually associated with episodes of local economic distress, such as the energy-sector problems that beset Houston in the mid–1980s.

Other metropolitan areas where housing busts were at least in part attributable to problems in the energy sector included Anchorage, AK; Casper, WY; Grand Junction, CO; Lafayette, LA; Oklahoma City, OK; and five metropolitan areas in Texas. The study also attributed early 1990s housing busts in parts of New England and Southern California to a combination of defense industry cutbacks, a slowdown in commercial real estate construction, and the effects of the 1990–91 recession. Finally, the busts recorded in Peoria, IL from 1984 through 1988 and Honolulu, HI from 1996 through 2001 were largely attributed to the effects of distress in the U.S. farm sector and the Japanese economy, respectively, and were both interpreted in the study as arising from outside the local housing sector itself.

The finding that housing booms do not necessarily lead to busts is somewhat reassuring from a risk management perspective. The periods of price stagnation that typically follow booms have not necessarily been associated with high mortgage credit losses to the degree that have sometimes been seen in bust markets. Rather housing stagnation tends to be characterized by steep declines in common measures of housing market activity, including new home sales, existing home sales, and housing starts. Home price stagnation can also be marked by declines in home prices that do not meet the FDIC's criteria for a bust.

The FDIC's analysis shows that average home prices fell in at least one year of the five years following a housing boom in 35 of the 54 booms that were identified. In 28 cases, the cumulative five-year change in home prices following the boom was negative, although only nine of these cases met the "15 percent" criteria for a bust.

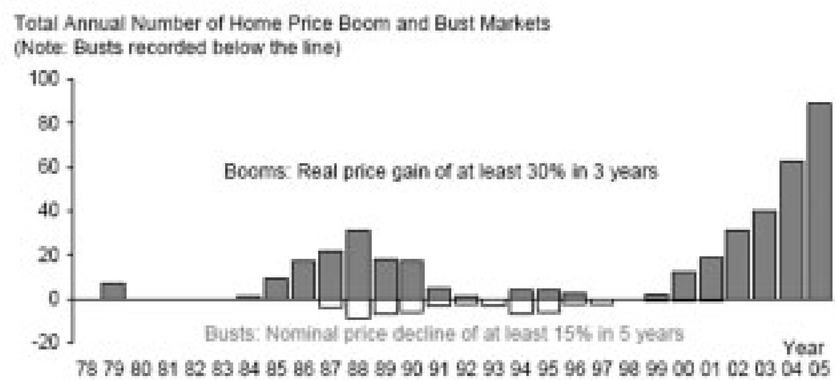
These periods of stagnation can be painful for homeowners, real estate investors, and others who make their living in real estate. In places like metropolitan New York, where prices fell by nine percent between 1988 and 1991, or Washington, D.C., where home prices remained essentially unchanged on average between 1990 and 1995, many can still recall the difficulties and disappointments they experienced trying to sell properties during the early 1990s. While often difficult in an individual situation, the credit implications of such periods of stagnation are much less severe, at least for mortgage loans, than situations where home prices decline sharply.

Current Boom Markets

Somewhat less reassuring, however, are the results derived by applying the studies' framework to the U.S. housing boom that developed during the first half of this decade and that now appears to be near an end.

Chart 5

The Number of U.S. "Boom" Housing Markets Nearly Tripled to 89 Between 2002 and 2005



Source: FDIC analysis based on OFHEO house price index (HPI). See C. Angell and N. Williams, "U.S. Home Prices: Does Bust Always Follow Boom?" FDIC, FYI, February 10, 2005.

Chart 5 tracks the number of boom markets from 1978 through 2005. It shows that the number of boom markets has grown rapidly all through this decade—accelerating after 2002 as the number of markets exceeded its previous 1988 peak and nearly tripling to 89 metropolitan areas. A listing of all recent boom markets and 3–year cumulative percent changes in average real home prices in these markets is provided in Table 3.

Table 3

Metro-Area Housing Booms, 2001-05, as Identified in FDIC Studies

Shaded cells indicate metro areas that meet criteria for home price "boom."
Cell entries reflect 3-year cumulative increase in house price index (HPI), adjusted for inflation.

Metro Area	2001	2002	2003	2004	2005
California					
Bakersfield, CA				48	75
Chico, CA			41	50	54
El Centro, CA					54
Fresno, CA			38	55	71
Hanford-Corcoran, CA				39	63
Los Angeles-Long Beach-Glendale Metro Div, CA			35	54	63
Madera, CA			35	57	71
Merced, CA		38	40	43	64
Modesto, CA		38	44	44	60
Napa, CA	44	46	33	41	45
Oakland-Fremont-Hayward Metro Division, CA	44	42			40
Oxnard-Thousand Oaks-Ventura, CA		38	35	54	58
Redding, CA			39	52	58
Riverside-San Bernadino-Ontario, CA			36	58	70
Sacramento-Arden-Arcade-Roseville, CA		37	40	47	55
Salinas, CA	43	46	33	38	58
San Diego-Carlsbad-San Marcos, CA	32	39	41	56	54
San Francisco-San Mateo-Redwd Cty Metro Div, CA	44	34			
San Jose-Sunnyvale-Santa Clara, CA	46	33			
San Luis Obispo-Paso Robles, CA	38	46	42	44	46
Santa Ana-Anaheim-Irvine Metro Division, CA		38	36	54	59
Santa Barbara-Santa Maria, CA	34	41	45	54	57
Santa Cruz-Watsonville, CA	45	39			33
Santa Rosa-Petaluma, CA	45	42			39
Stockton, CA	36	38	36	38	56
Vallejo-Fairfield, CA	40	45	39	41	50
Visalia-Porterville, CA				36	64
Yuba City, CA			43	56	68
Other Western					
Bellingham, WA					42
Bend, OR					30
Boulder, CO	31				
Bremerton-Silverdale, WA					31
Carson City, NV				44	60
Coeur d'Alene, ID					41
Flagstaff, AZ-UT					41
Honolulu, HI				36	51
Las Vegas-Paradise, NV				44	61
Medford, OR				32	50
Olympia, WA					
Phoenix-Mesa-Scottsdale, AZ					43
Prescott, AZ					41
Reno-Sparks, NV				41	61
St. George, UT					34
Tucson, AZ					36
Yuma, AZ					46
New England					
Barnstable Town, MA	42	45	43	44	34
Boston-Quincy Metro Division, MA	35	38	34	32	
Cambridge-Newton-Framingham Metro Division, MA	34	34			
Essex County Metro Division, MA	33	36	36		
Manchester-Nashua, NH		35	32		
Norwich-New London, CT				31	31
Portland-South Portland-Biddeford, ME				36	
Providence-New Bedford-Fall River-Warwick, RI		34	35	46	39
Rockingham County-Strafford County Metro Div, NH	31	35	36		
Worcester, MA-CT		34	33	31	

Continued on next page

Table 3

Metro-Area Housing Booms, 2001-05, as Identified in FDIC Studies

Shaded cells indicate metro areas that meet criteria for home price "boom."
Cell entries reflect 3-year cumulative increase in house price index (HPI), adjusted for inflation.

Continued from previous page

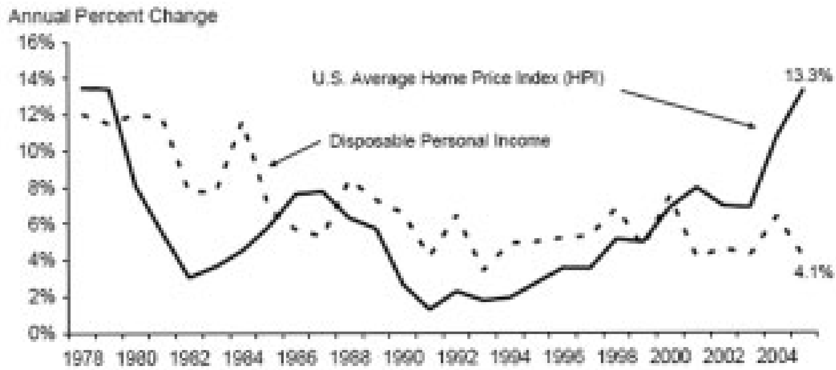
Metro Area	2001	2002	2003	2004	2005
Northeast and Middle Atlantic					
Albany-Schenectady-Troy, NY					56
Atlantic City, NJ				40	48
Baltimore-Towson, MD				56	45
Bethesda-Frederick-Gaithersburg Metro Div, MD			32	41	46
Camden Metro Division, NJ				33	37
Charlottesville, VA					34
Dover, DE					56
Edison Metro Division, NJ		31	34	39	38
Glens Falls, NY					33
Hagerstown-Martinsburg, MD-WV				30	45
Kingston, NY			33	42	48
Nassau-Suffolk Metro Division, NY	31	37	37	41	38
New York-Wayne-White Plains Metro Division, NY		30		34	35
Newark-Union Metro Division, NJ				32	32
Ocean City, NJ		37	37	46	43
Philadelphia Metro Division, PA				30	32
Poughkeepsie-Newburgh-Middletown, NY			35	41	38
Salisbury, MD					37
Trenton-Ewing, NJ				33	34
Vineland-Millville-Bridgeton, NJ					34
Virginia Beach-Norfolk-Newport News, VA-NC				31	47
Washington-Arlington-Alexandria Metro Div, DC			31	40	51
Wilmington Metro Division, DE					32
Winchester, VA-WV				36	51
Florida					
Cape Coral-Fort Myers, FL			31	58	57
Deltona-Daytona Beach-Ormond Beach, FL				55	53
Fort Lauderdale-Pompano Bch-Deerfld Bch, FL MetDiv		30	38	46	59
Fort Walton Beach-Crestview-Destin, FL				33	63
Gainesville, FL					34
Jacksonville, FL					32
Lakeland, FL					36
Miami-Miami Beach-Kendall Metro Division, FL			37	48	58
Naples-Marco Island, FL		32	31	36	59
Ocala, FL					38
Orlando-Kissimmee, FL					42
Palm Bay-Melbourne-Titusville, FL				44	66
Panama City-Lynn Haven, FL				31	58
Pensacola-Ferry Pass-Brent, FL					38
Port St. Lucie-Fort Pierce, FL			37	54	63
Punta Gorda, FL			31	43	59
Sarasota-Bradenton-Venice, FL				37	56
Tallahassee, FL					31
Tampa-St Petersburg-Clearwater, FL					41
Vero Beach, FL				38	59
W. Palm Beach-Boca Raton-Boynton Bch Mtro Div, FL			33	48	63

Source: Adapted from: Cynthia Angell and Norman Williams, "FYI Revisited: U.S. Home Prices – Does Bust Always Follow Boom?" Federal Deposit Insurance Corporation, *FYI*, May 2, 2005. Update for 2005 reflects both new data and revised metro area definitions.

As in previous housing booms, recent boom markets have continued to be concentrated in the Northeast, the Middle Atlantic States, California, the Northwest, and areas of the Mountain West States. The state of Florida, which had never experienced a boom market according to the FDIC's criteria between 1977 and 2002, was home to 21 boom markets as of 2005.

Factors shared by many boom markets—particularly those that had recurrent booms across time—include a combination of vibrant economies that are generating jobs and drawing in new residents, or a scarcity of available land on which to build new homes to meet demand, or both. By contrast, metropolitan areas in the middle of the country that depend more heavily on agriculture and manufacturing, and where land is readily available, have generally had much lower rates of home price appreciation in this decade.

Chart 6
Recent U.S. Home Price Increases Have Outpaced Income Gains by a Wide Margin



Source: OFHEO, Bureau of Economic Analysis.

However, the intensification of the home price boom sinc 2002 has been unprecedented in scale as well as in scope. Chart 6 tracks annual changes at the national level in both the OFHEO home price index and disposable personal incomes, both measured in nominal terms. It shows that while disposable incomes have grown slightly faster than average home prices during most years, home prices began to grow faster than incomes beginning in 2001 much the same as they had during previous boom periods in 1978-79 and 1986-87. What stands out in Chart 6 is the acceleration of average U.S. home price growth to double-digit rates in 2004 adn 2005. Average U.S. home prices grew more than three times faster than disposable incomes in 2005.

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Recent Changes in Mortgage Markets

In seeking to explain the recent acceleration in home price growth, the FDIC analysts in their May 2005 *FYI* study pointed to important changes in the mortgage lending business in 2004 and 2005 that may be related to the acceleration of home price growth. Certainly, low short-term and long-term interest rates are factors that have helped to support home price growth in recent years. However, in 2004, just as short-term interest rates were beginning to rise, borrowers began to migrate toward adjustable-rate mortgages (ARMs) that are commonly indexed to short-term interest rates.

According to the Federal Housing Finance Board, over 30 percent of all conventional mortgages closed in 2004 and 2005 were ARMs. The ARM share moderated to 25 percent by the second quarter of 2006. The percentage of ARMs among subprime mortgages is higher. Within subprime mortgage backed securities, the share of ARMs was far higher, close to 80 percent.[5] The prevalence of subprime

[5] See "ARMs Power the Subprime MBS Market in Early 2006," *Inside B&C Lending*, July 21, 2006. Subprime mortgages are higher-interest mortgages that involve elevated credit risk. For more on subprime mortgages, see C. Angell, "Breaking New Ground in U.S. Mortgage Lending,"

Continued

loans among all mortgage originations doubled from 9 percent in 2003 to 19 percent in 2004.[6]

One possible explanation for the shift toward ARMs and subprime loans is that prime borrowers with a preference for fixed-rate mortgages refinanced in record numbers as long-term interest rates fell to the lowest rates in a generation in 2003. This refinancing boom may have tended to skew the composition of mortgage loans in 2004 and 2005 more toward subprime and ARM borrowers. Another explanation might be that new homebuyers were increasingly using the lower monthly payments associated with ARMs to cope with rapidly rising home prices.

Adjustable-rate mortgage borrowers also increasingly turned to interest-only and payment option loan structures in 2004 and 2005.[7] These mortgages are specifically designed to minimize initial mortgage payments by eliminating or relaxing the requirement to repay principal during the early years of the loan. Although it is difficult to measure the use of these mortgage structures across all mortgage originations, they appear to have made up as much as 40 to 50 percent of all loans securitized by private issuers of mortgage-backed securities during 2004 and 2005.

Finally, there is evidence that a significant proportion of mortgage loans were made to real estate investors in 2004 and 2005. The National Association of Realtors found that 28 percent of all homes purchased in 2005 were for investment rather than occupancy by the buyers, up from 25 percent in 2004.[8] This high share signals an increase in speculative purchases of residential properties, particularly condominiums. While speculative buying is a fairly common feature of housing booms, this activity deserves particular mention when home price increases have been so large and when use of nontraditional mortgages has increased as much as in the past two years.

Implications for the Future Path of U.S. Home Prices

After undergoing a boom of historic proportions in recent years, a variety of recent indicators show that housing market activity is waning in most areas of the nation. Sales of new homes in July 2006 were 22 percent lower than a year ago, while sales of existing homes were down 11 percent. Home price increases in most markets appear to be tapering off to single-digit rates, while small price declines have been seen in a number of markets located in the upper Midwest states.

The FDIC's analysis of metropolitan-area boom and bust cycles over a period of almost 30 years indicates that the metropolitan-area housing booms that have recently occurred in record numbers cannot last indefinitely. In their aftermath, there will almost certainly be one of two possible outcomes: (1) a period of stagnation with weak home prices and even weaker measures of housing market activity; or (2) a price bust, or a sharp decline in home prices with severe adverse consequences for homeowners, lenders and the real estate sector as a whole.

The historical experience clearly implies that a widespread price bust remains an unlikely outcome for two reasons. One is that historically price busts are typically associated with severe local economic distress that arises from outside the housing sector itself. While recent macroeconomic performance has benefited a great deal from expansion in the housing sector, the prospects appear good that the solid growth in jobs and incomes that has occurred in recent quarters will continue to be supported by other sectors of the economy, including business investment, exports and nonresidential construction.

FDIC Outlook, Summer 2006. *http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006_summer04.html*.

[6] See "Mortgage Originations by Product," *Inside Mortgage Finance*, February 25, 2005.

[7] In an interest-only (IO) mortgage, the borrower is required to pay only the interest due on the loan for the first few years, during which time the rate may be fixed or fluctuate. After the IO period, the rate may be fixed or fluctuate based on the prescribed index; payments consist of both principal and interest. In a payment option ARM, the borrower may choose from a number of payment options that may include options that allow for negative amortization—an increase in the principal balance of the loan. For more on these loan types, see C. Angell, "Breaking New Ground in U.S. Mortgage Lending," FDIC Outlook, Summer 2006. *http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006_summer04.html*.

[8] "Second Home Sales Hit Another Record in 2005; Market Share Rises," NAR, April 5, 2006, *http://www.realtor.org/PublicAffairsWeb.nsf/Pages/SecondHomeSales05?OpenDocument*. Loan data compiled by LoanPerformance Corporation from its loan-service companies found that 9.5 percent of home-purchase mortgages in 2005 were for investors, up from 8.6 percent in 2004. The discrepancy between the two reports may lie in differences in data collection and reporting. LoanPerformance does not capture data on homes purchased without a loan, and some investors may not identify themselves as such to lenders in order to avoid higher rates typically charged to investors. "Investment Homes To Get Less Focus, Realtors Predict," The Wall Street Journal, April 6, 2006.

The second reason a home price bust remains an unlikely outcome is the anticipated response on the part of homeowners to weakness in their local real estate market. As was mentioned earlier in my testimony, home prices tend to be "sticky downward" in large part because homeowners are usually extremely reluctant to sell their homes at a loss unless forced to do so by the relocation or loss of their jobs. Under a wide range of adverse economic scenarios, homeowners have proven to go to extraordinary lengths to avoid selling their homes at a loss. Most commonly, they will simply choose to remain in them, or to rent them so as to cover at least part of their debt service costs. While the reluctance to sell has the effect of limiting the extent of the decline in home prices, the resulting period of stagnation can last for years.

The exception to this rule has been episodes of severe local economic distress that produce large job losses, declines in personal incomes, and, in many cases, out-migration to other areas where job prospects are brighter. While such circumstances remain possible in areas dominated by troubled industry sectors, they will remain the exception rather than the rule.

What is yet to be determined is the effect that recent changes in the mortgage lending business may have on the ability of homeowners to meet their monthly obligations under adverse housing market conditions. While adjustable-rate mortgages are not new in the marketplace, many of the newly popular interest-only and payment option structures may lead to a significant increase in monthly payments due to higher short-term interest rates or simply the expiration of low introductory interest rates. It remains uncertain how much the "payment shock" associated with these structures may contribute to selling pressure in local housing markets on the part of distressed homeowners or lenders looking to sell foreclosed properties.

It is important to note that the overall prevalence of nontraditional mortgage structures remains fairly limited. While total ARMs originated in 2004 and 2005 are estimated to represent approximately 22 percent of all U.S. mortgage loans, it is likely that just under half that amount is comprised of interest-only and payment option structures.[9] Borrowers who took on nontraditional loans as a means to afford a more expensive home may be particularly vulnerable to adverse housing market conditions. However, other borrowers who have used these structures to help manage their wealth or compensate for irregular income streams will be less severely affected.

Conclusion

In conclusion, FDIC studies indicate that housing price booms historically have not necessarily been followed by housing price busts. Instead, they found that housing busts were usually associated with episodes of local economic distress, such as the energy-sector problems that beset Houston in the mid–1980s. Housing booms are more frequently followed by periods of housing stagnation that tend to be characterized by steep declines in common measures of housing market activity, including new home sales, existing home sales, and housing starts. Home price stagnation can also be marked by declines in home prices that do not meet the FDIC's criteria for a bust.

Although housing price booms have not necessarily been followed by housing price busts, there are two factors in today's markets that are different from the historical experience. The number of boom markets is substantially higher currently than the historical experience. In addition, the use of ARMs and non-traditional mortgage products is unprecedented and could have an impact on future market performance.

This concludes my testimony. I will be happy to respond to any questions the Subcommittees might have.

PREPARED STATEMENT OF DAVID SEIDERS

CHIEF ECONOMIST, NATIONAL ASSOCIATION OF HOMEBUILDERS

SEPTEMBER 13, 2006

THE HOUSING DOWNSWING: CAUSES, DIMENSIONS AND ECONOMIC CONSEQUENCES

Chairman Allard, Chairman Bunning, Ranking Member Reed, and Ranking Member Schumer, my name is David Seiders and I am the Chief Economist for the National Association of Home Builders (NAHB). I am pleased to appear before you today to share NAHB's views on the outlook for housing and the economy. NAHB

[9] "Mortgage Payment Resets: The Rumor and the Reality," C. Cagan, First American Real Estate Solutions, February 8, 2006.

represents 235,000 member firms involved in home building, remodeling, multi-family construction, property management, housing finance, building product manufacturing and other aspects of residential and light commercial construction.

Summary and Conclusions

The U.S. housing market exhibited "boom" conditions during most of the 2004–2005 period but home sales and housing production now are coming down. Indeed, housing has already swung from a powerful engine of economic growth to a significant drag on the economic expansion, and there are serious questions about the impacts of housing on the economy going forward.

This statement outlines the basic causes of the current housing downswing, estimates the depth and duration of the downswing, and discusses the likely economic consequences of the falloff in housing market activity as well as the likely impacts of several secondary effects of the evolving housing cycle. The basic conclusions are as follows:

- Both the housing boom of 2004–2005 and the current housing contraction have unique features that make them substantially different from previous housing market swings. The big differences relate primarily to unusually stimulative financial market conditions during the boom, record-breaking increases in inflation-adjusted house prices, and an outsized presence of investors/speculators in single-family and condo markets.
- The current contraction amounts to an inevitable mid-cycle adjustment, or transition, from unsustainable levels of home sales, housing production and house price appreciation to levels that are supportable by underlying market fundamentals.
- The previous boom involved more than two years of unsustainable housing market activity, and we're likely to experience a below-trend performance of home sales and housing starts of roughly similar duration. The downswing in home sales and housing production should bottom out around the middle of next year before transitioning to a gradual recovery that will raise housing market activity back up toward sustainable trend by the latter part of 2008.
- National average house price appreciation is likely to be quite limited in the near term. Indeed, some decline is a distinct possibility, and the rate of price appreciation should remain below trend for some time. "True" house price appreciation, accounting for upward bias in key price measures as well as price support from non-price sales incentives provided by sellers, presumably will be even weaker.
- The downswing in home sales and housing production will continue to detract from overall economic growth through mid–2007. However, much of this negative impact should be offset by strengthening activity in other sectors of the U.S. economy, keeping GDP growth reasonably close to a sustainable trend-like performance.
- There are bound to be some adverse secondary effects of the recent housing boom and the subsequent downswing on the ongoing economic expansion. These effects include negative impacts on consumer spending from a fading wealth effect as house prices adjust as well as from the impacts of "payment shock" on homeowners facing upward adjustments to monthly payments on "exotic" types of adjustable-rate mortgages (ARMs) originated since 2003. However, the size and timing of these effects are not likely to seriously threaten the economic expansion.
- The housing and economic outlook characterized above rests on a number of key conditions, and downside risks to the outlook are considerable. These risks include the possibility of spikes in interest rates or energy prices as well as large resales of homes back onto the markets by investor/speculators. There also are considerable uncertainties about the true dimensions of the risk facing homeowners with "exotic" ARMs, and there are major uncertainties regarding the size of the inventory overhang in the market for new homes.

Causes of the Housing Downswing

The roots of the current housing downswing were cultivated before and during the housing boom of 2004–2005. The housing boom actually was touched off by the extraordinary monetary stimulus enacted by the Federal Reserve to fight off the threat of price deflation in the U.S. economy. The Fed dropped the federal funds rate to 1 percent at mid-2003 (a negative "real" rate), held it there through mid-2004 and then embarked on a gradual path back toward monetary "neutrality"—a journey that didn't reach its goal until the early part of this year. Furthermore, the extraordinary degree of monetary stimulus in the U.S., together with low long-term rates abroad, kept long-term interest rates in the U.S. at historic lows during most of the 2003–2005 period. This extremely favorable financing environment fueled buying activity in the interest-sensitive housing sector, pulling some demand forward in the process.

The surge in housing demand quickly put substantial upward pressure on house prices, aided and abetted in many parts of the country by land-use constraints that limited the amount of supply that builders could bring onto the markets in short order. Surging prices bolstered expectations of future price appreciation, driving down the user cost of capital and bolstering the investment aspects of homeownership. The extremely favorable tax treatment of capital gains on housing (enacted in 1997) certainly contributed to these developments.

The extraordinarily low interest rate structure and the rise in house price expectations attracted many households out of rental apartments and into first-time homeownership, driving both the homeownership rate and the rental vacancy rate to record highs by early 2004. Furthermore, waves of investors/speculators bought into the single-family and condo markets to share in the unprecedented real capital gains being generated—at a time when our stock market was in questionable condition, yields on interest-bearing investments were at rock bottom and it was difficult to find attractive investment alternatives in foreign markets.

The mortgage lending community also contributed to the housing boom, marketing a wide range of "exotic" ARMs (to coin a Greenspan term) that were designed to help get prospective buyers (including subprime credit risks) into homeownership and to accommodate investors/speculators with short-term investment objectives. These lending practices naturally fueled demand further, adding to the already considerable upward pressures on prices of single-family homes and condo units. Both federal regulators of depository institutions and financial rating agencies raised flags about overly aggressive mortgage lending practices, particularly payment-option ARMs that permit negative amortization, but these flags apparently had little influence on lending practices in either the regulated or unregulated markets.

The ongoing accumulation of large house price increases began to weigh on housing affordability measures by the early part of 2004, despite the stubbornly low interest rate structure. However, proliferation of the "exotic" ARMs kept a lot of prospective homeowners in the game, particularly in relatively high-priced markets. Meanwhile, the investors/speculators continued to plough ahead, still drawn by the lure of future price appreciation.

Home sales and house price appreciation kept rising to higher and higher records throughout 2004 and into 2005, and the affordability measures kept falling. Affordability was subject to additional downward pressure after mid-2005 as the whole interest rate structure finally shifted upward, and the aggregate demand for homes finally started to give way in the third quarter of last year.

The combination of fading demand on the part of prospective homeowners and a supply train that still was moving ahead quickly changed a raging "sellers' market" into a market where inventories were climbing and buyers could shop and bargain. Symptoms of the switch naturally caught the attention of savvy investors who cut back on buying, started cancelling sales contacts before closing and even started reselling vacant units they had closed on earlier.

In retrospect, it was the finance- and price-driven acceleration of buying for homeownership and for investment that drove housing market activity into unsustainable territory during the boom. We're now experiencing a "payback" in demand for homeownership, following the surge that pulled demand forward into the boom years, and net purchases by investors/speculators are coming down considerably as price expectations are being marked down.

Dimensions of the Housing Downswing

The 2004–2005 housing boom took home sales and housing production well above levels supportable by demographics and other fundamental demand factors. The cumulative excess of housing starts apparently amounted to at least 400 thousand units, and the excess supply now resides in builder inventories or in the hands of investors who may cancel contracts or sell vacant units at any time. In this regard, it's worth noting that the single-family rental vacancy rate soared to record highs during the boom, came down to some degree during the first half of this year, and presumably is heading lower for some time.

It's clear that the housing downswing still has some distance to go, if only to work off excess supply in markets for both new and existing homes (including the condo market). Builders are cutting back on new permit authorizations as well as on starts of new units, and they are trimming prices and offering sizeable non-price sales incentives to limit cancellations and bolster sales. Furthermore, various economic and financial market fundamentals figure to be supportive of housing demand for the foreseeable future, helping to facilitate the inventory correction. These fundamentals include the following:

- Payroll employment growth is proceeding at a decent and sustainable pace.
- Household income growth is strengthening as the economic expansion proceeds.
- The interest rate structure is favorable, mortgage credit is readily available and monetary policy has stabilized following a long run of upward rate adjustments.
- Energy prices have receded from record highs earlier this year.

As long as the economy remains in good shape, interest rates remain close to current levels, energy prices remain below recent highs and sellers of new and existing homes adjust prices or offer incentives to fit current market realities, the rest of the housing market correction should be of limited depth and duration. It's likely that the bulk of the downswing in home sales and housing production will occur this year, with market activity stabilizing around mid-2007 and moving back up toward trend by late 2008. NAHB's forecast has a cumulative shortfall of housing starts (below our estimate of sustainable trend) of roughly 400 thousand units from the middle of this year through the end of 2008, in line with the estimated excess supply generated during the boom period.

House Price Adjustments

House price appreciation was very rapid during the housing boom, and "real" house price appreciation soared to record rates. The national appreciation rate has slowed considerably since then, in both nominal and real terms, as sales volume has fallen and inventories of both new and existing homes have climbed. Absolute price declines actually were recorded for some markets in the second quarter of this year, although most of these markets were located in the beleaguered economies of the Great Lakes region rather than in previously overheated areas.

The size of the current inventory overhang and the marked slowdown in price appreciation that's already occurred point toward a generalized flatness in nominal house prices in the near term, and some price erosion certainly could occur in coming quarters. In any case, an extended period of below-trend national house price appreciation lies ahead, and "real" house prices should come down to some degree. These adjustments certainly will give a boost to affordability for prospective homeowners as time passes.

It's worth noting that all available measures of house price appreciation have technical deficiencies—even the purchase-only version of OFHEO's quarterly repeat-sales House Price Index. This measure is not reflective of the entire market, it contains some upward bias because it does not account for improvements to homes over time, and there's no way to adjust price appreciation downward to account for non-price sales incentives provided by sellers. Despite these limitations, it's the best available gauge of house price change in the U.S. as well as in regions, states and metro areas.

Economic Consequences of the Housing Downswing

The U.S. economy can continue to grow at close to a trend pace even as the downswing in home sales and housing production runs its course. For one thing, the housing correction is a relatively isolated sectoral event, primarily reflecting recoil from earlier excesses within the sector. Unlike previous downswings, housing affordability has been squeezed primarily by price increases and the normally close correlation between housing activity and other interest-sensitive components of aggregate demand is not strong this time.

It's also true that the housing downswing is occurring at the same time that other sectors of the economy are in mid-cycle expansion phases. This apparently is true of spending on capital equipment and software, nonresidential structures and exports. This type of sectoral rotation actually could give new life to the economic expansion (now nearly 5 years old), and the net outcome could very well be trend-like GDP growth with manageable core inflation and reasonably stable interest rates. That's an environment where housing would be able to deliver healthy trend-like performances of its own, riding on strong demographic trends and other fundamental demand factors.

Household Wealth and Consumer Spending

The ongoing deceleration of house prices, and possible national house price declines, will take some strength out of consumer spending. After all, the rapid runup in house values and household wealth clearly fueled consumption expenditures during the housing boom, allowing the personal saving rate to go negative for an extended period of time. Furthermore, much of this spending was financed via borrowing against accumulated housing equity (cash-out refinancings and home equity loans) at a time when interest rates were lower than now.

It's true that the housing wealth effect on consumer spending will be weakening to some degree as house prices slow and possibly even decline, but the erosion of support to consumer spending should be gradual over time and occur primarily after the downswing in home sales and housing production has run its course and residential fixed investment has completed its contraction (mid-2007). Households typically react to changes in wealth with long lags (one to three years), and the influence of the recent dramatic wealth buildup on consumer spending should carry through for some time.

With respect to the influence of increases in the cost of accessing housing wealth via mortgage borrowing, a wealth of research shows that it's the wealth (or net worth) effect that really matters, not the amount of housing equity that's "withdrawn" via mortgage borrowing. Wealth-driven consumer expenditures can be financed by spending more out of current income (for those with positive savings), by running down financial assets or by using non-mortgage debt (e.g., personal loans).

Mortgage Payment Shock

The proliferation of "exotic" ARMs during the housing boom (payment-option, interest-only, etc.) has raised the specter of widespread "payment shock" for homeowners when such loans hit their first rate resets and/or when the loans begin to require repayment of principal. These adjustments, when they occur, will put heavier demands on household budgets, with downside implications for consumer spending, and some homeowners will be forced into delinquency and even loan default. Subprime mortgage borrowers presumably are the most at risk.

There's no doubt that the surge of "exotic" ARMs, and the associated relaxation of lending standards at both regulated and unregulated financial institutions, helped fuel the housing boom and will be creating problems for some homeowners. However, most outstanding mortgage debt is either fixed-rate or standard types of ARMs, and household income growth since loan origination should enable the majority of homeowners facing ARM payment adjustments to handle the higher monthly payments. Price appreciation since origination also will provide a financial buffer for many of those facing unanticipated increases in monthly payments.

Homeowners facing large payment adjustments on exotic ARMs also can refinance into other types of ARMs or into fixed-rate mortgages at historically low rates, and most of the "exotic" ARMs apparently do not carry substantial prepayment penalties.

It's also worth remembering that there was a strong correlation, across metro areas, between the frequency of "exotic" ARMs and investor shares of home mortgage originations. Many investors apparently used these types of loans to minimize short-term financing costs, and many presumably will be paid off or refinanced before upward payment adjustments occur.

Everything considered, payment shock associated with "exotic" ARMs written during the boom will most likely be a negative for consumer spending in the next few years but should not threaten the projected economic expansion.

Downside Risks

The housing and economic outlook described above rests on a number of key conditions, and downside risks to the outlook are considerable. Housing forecasts always are subject to the risk of unanticipated interest rate spikes, and reluctance by foreign investors to continue to finance our huge current account deficit could put serious upward pressure on the U.S. interest rate structure. Furthermore, recent experience in energy markets suggests that a major surge in energy prices can't be ruled out.

There also are major uncertainties about the prospective behavior of the unprecedented numbers of investors/speculators that bought single-family homes and condo units during the boom. NAHB's surveys of builders show large numbers of cancellations of sales contracts before closing as well as less-frequent reports of resales of units closed on earlier. Our forecasts assume that any reflow of units back onto the markets is of manageable proportions and that wholesale dumping does not materialize.

The prospective impact of payment resets on "exotic" ARMs, particularly payment-option ARMs with negative amortization, also is difficult to predict. It's possible to estimate the volume of potentially troublesome loans outstanding as well as the approximate timing of the first payment resets. However, there are a lot of uncertainties about the quality of loan underwriting during the boom housing years, including the degree of "layering" of permissive lending practices, and it's hard to predict the ultimate outcome on loan quality and consumer spending.

Another uncertainty relates to the true size of the inventory of new homes for sale. The Commerce Department's estimates exclude homes left with builders when sales contracts are cancelled, and cancellations have been rising sharply since this time last year. NAHB's forecast attempts to account for this factor, but the true size of the inventory overhang remains a grey area at best.

Mr. Chairman, that concludes my remarks. Again, thank you for the opportunity to appear before this joint subcommittee today. I look forward to answering any questions you or the members of the joint subcommittee have for me.

PREPARED STATEMENT OF TOM STEVENS

PRESIDENT, NATIONAL ASSOCIATION OF REALTORS®

SEPTEMBER 13, 2006

Chairmen Allard, Bunning and Ranking Members Schumer and Reed, and Members of the Subcommittees, my name is Tom Stevens, and I am the former President of Coldwell Banker Stevens (now known as Coldwell Banker Residential Brokerage Mid-Atlantic)—a full-service realty firm specializing in residential sales and brokerage. Since 2004, I have served as senior vice president for NRT Inc., the largest residential real estate brokerage company in the nation.

As the 2006 President of the National Association of REALTORS®, I am here to testify on behalf of our nearly 1.3 million REALTOR® members. We thank you for the opportunity to present our views of the current real estate market as well as prospects for the future. NAR represents a wide variety of housing industry professionals committed to the development and preservation of the nation's housing stock and making it available to the widest range of potential homebuyers. The Association has a long tradition of supporting innovative and effective housing programs and we continue to work diligently with the Congress to fashion housing policies that ensure housing programs meet their mission responsibly and efficiently.

For the past five years, the housing market has been a steadfast leader in the U.S. economy. In 2005, mortgage rates remained near 45-year lows while the nation's economy generated 2 million net new jobs. Existing-home sales rose 4.4 percent in 2005, resulting in five successive record years. Both new-home sales and new single-family housing starts also set new high marks in 2005. Overall, the housing sector directly contributed more than $2 trillion to the national economy in 2005, accounting for 16.2 percent of economic activity. In addition, commercial real estate contributed an additional $330 billion to the nation's economy.

After five years of outstanding growth and being the driving force of the U.S. economy, the housing market is undergoing a period of adjustment. I have experienced this first hand as my prior home has been on the market, in Northern Virginia, for over a year. Existing home sales in July fell 11.2 percent from a year ago. New home sales are down 22 percent from a year ago. The inventory of unsold homes on the market is at an all-time high of 3.9 million, which is a 40 percent rise from a year ago. Given the falling demand and increased supply, home prices have seen less than 1 percent appreciation from a year ago compared to the double-digit rate of appreciation in 2005.

While recent developments raise concerns, it is important to remember that the housing market varies significantly across the country. One-third of the country (by population) is still seeing rising home sales. They include Alaska, Vermont, New Mexico and many states in the South (excluding Florida). The remaining two-thirds of the country is experiencing lower sales with some states feeling acute adjustment pains. Sales are down significantly in Florida, California, Arizona, Nevada, Virginia, and Maryland. These regions experienced the greatest rise in home prices in recent years and affordability has become a major issue. The sharp decline in sales have resulted in a much higher housing inventory (tripling and quadrupling in some cases) and these areas are vulnerable to outright price declines, particularly if interest rates were to rise further.

The industrial Midwest region did not participate in the nationwide housing market boom of the past five years due to weaker job market conditions. Job gains have been minimal in Ohio and Indiana during the recent nationwide economic expansion. Job losses have been continuing in Michigan—for five straight years.

Contrary to many reports, there is not a "national housing bubble." All real estate is local. For example, the housing market in California is extremely different from

Oklahoma. Home price-to-income ratio, home price-to-rent ratio, and more importantly, mortgage debt servicing cost-to-income ratio have greatly increased in some markets to worrisome levels. Markets in Florida, California, Arizona, Nevada, Virginia, and Maryland exhibit trends far above the local historical norm, thus it would not be surprising for these markets to experience a price adjustment. However, these states have solid job growth—Because of solid job growth, price declines are likely to be short-lived as new job holders provide demand and support for the housing market.

If the mortgage rates were to rise measurably—to say 7.5 percent or 8 percent from the current 6.5 percent—for whatever reasons (be it Chinese dumping dollars on the market, higher inflationary expectations, or monetary tightening by the Federal Reserve) then the housing market would certainly come under more pressure and many markets would likely undergo price declines.

The most influential factor is the rising mortgage rates. Many homebuyers in coastal markets have resorted to more exotic mortgages. Due to very high home prices, interest-only, adjustable rate, and/or option-ARMS became the only way to enter the housing market for some homebuyers. In essence, the homebuyers in the coastal markets are at their financial capacity. With rising mortgage rates, homebuyers are becoming exhausted financially, which explains why sales have tumbled in high priced regions of the country. In the industrial Midwest, as I said earlier, the housing market is more job market dependent and less mortgage rate dependent.

Another factor is the insufficient presence of Government Sponsored Enterprises (GSEs) and the Federal Housing Administration (FHA) in the high priced regions. The increases in GSE/FHA loan limits have not kept pace in places like California, Florida, and parts of New York among others. For example, loan limits rose 7.8 percent in 2005 while home prices rose 19 percent in Los Angeles, 25 percent in the D.C., and 30 percent in Miami. Consider, for a moment, that FHA's share of loans in Los Angeles went down from nearly 20 percent in 2000 to essentially zero today.

As you know, FHA loans often serve neglected demographic segments of the housing market—first time, lower income, minority, and immigrant homebuyers. NAR applauds the Bush Administration's FHA reform proposal currently being considered in Congress. A modernized FHA will be a valuable tool to people seeking to buy a home in softer housing and mortgage markets. As we have seen in the past, in soft local and regional markets, FHA has filled significant gaps in the private sector lending market, becoming the predominant tool to achieve homeownership and helping to carry regions out of an economic downturn. In the mid 1980s, in Colorado, Oklahoma, Louisiana, and Texas, the FHA loan program stepped in, while private mortgage providers left those in distressed economic areas, and took over a substantial role in providing available mortgage credit to those in affected states. An FHA with the tools to complete the task will be important to thousands of Americans hoping to buy a home, but in particular, in those markets that really need the help.

Florida has also been hit by another unique factor—the lack of affordable property insurance. The unprecedented number of strong hurricanes hitting the Florida shores in 2004 and 2005 has resulted in a dysfunctional insurance market where premiums have either increased—literally through the roof—or are simply not available. We have heard many stories from our membership in Florida about how potential homebuyers backed away at the last moment either due to the insurance sticker shock or due to outright unavailability of insurance.

The national forecast for the coming year, based on stabilizing mortgage rates and a modestly expanding economy through 2007, predicts that existing home sales will fall 8 percent in 2006 followed by another 2 percent decline in 2007. New home sales will fall by an even greater amount of 16 percent in 2006 and then 7 percent in 2007. Home price growth will be minimal (less than 3 percent) in both of these years, again, it is important to remember that all real estate is local. Therefore, some local markets will not comport with the national forecast. Any significant shift in mortgage rates and the state of the economy will also alter the outlook.

Based on the housing market forecast mentioned above, the residential construction spending portion of the economy will contract 3.4 percent in 2006 and 8.5 percent in 2007. In other words, $21 billion will be subtracted from GDP in 2006 and another $49 billion slashed in 2007. That would be a sharp contrast to the near $50 billion in additions during the housing market boom.

The more important contribution of the housing sector has not been in the direct employment of real estate agents, mortgage lenders, construction workers, or expansion of Home Depot and Lowe's to name a few. Consumer spending of all things (from furniture and autos to travel and education) has been greatly supported by the increase in housing equity accumulation. A typical homeowner in the U.S.

gained $72,300 in housing equity in the past five years, including over $20,000 just last year. Nearly all economists will say that consumer spending has been far more robust than can be explained by income growth, job gains, and stock market gains. GDP growth would have been 1.5 percent points lower had the housing market not provided the wealth accumulation in recent years.

NAR understands that the housing sector could not maintain a record setting pace indefinitely. A soft landing is certainly possible and under the right circumstances likely, but that soft landing is critically dependent upon policies that support a transition to a more normalized market and mitigate changes in local markets in the availability of mortgage financing and other essential elements to homeownership.

In conclusion, the National Association of REALTORS® commends the Subcommittees for holding this important hearing and for its leadership in fashioning housing and economic policies that stimulate the U.S. economy. The NAR stands ready to work with Congress to continue to open the door to the American Dream—Homeownership. This concludes my testimony and I look forward to answering any questions you may have.

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

HOUSING POLICY COUNCIL,
THE FINANCIAL SERVICES ROUNDTABLE,
Washington, DC, September 12, 2006.

Senator WAYNE ALLARD,
Chairman, Subcommittee on Housing and Transportation

Senator JIM BUNNING,
Chairman, Subcommittee on Economic Policy, US Senate Committee on Banking, Dirksen Senate Office Building, Washington, DC.

DEAR CHAIRMAN ALLARD AND CHAIRMAN BUNNING: Thank you for holding a joint Subcommittee hearing on the current state of the U.S. housing market. This is a timely subject and the Housing Policy Council (HPC) welcomes the opportunity to share its views on this issue and an important step that Congress can take to provide increased support and protection for our Nation's housing finance system.

The Financial Services Roundtable's Housing Policy Council's members are twenty-two of the nation's leading mortgage finance providers. We estimate that Housing Policy Council member companies originate over sixty-four percent of mortgages for American consumers. The Financial Services Roundtable is the national trade association of one hundred of the nation's leading diversified financial services companies.

As your subcommittees considers data on the current state of the nation's housing market, we urge you to keep in mind that Congress can take a very strong step to insure the safety and soundness of the housing finance system by passing legislation to strengthen the regulatory oversight of the housing GSEs. The GSEs—Fannie Mae, Freddie Mac and the Federal Home Loan Bank System are integral parts of the secondary mortgage market. Their safety and soundness is essential to effectively managing changes in the housing market. The current regulatory system, particularly the statutory authority of the Office of Federal Housing Enterprise Oversight (OFHEO) is currently inadequate to effectively regulate Fannie Mae and Freddie Mac in the increasingly complex housing finance system.

As you will hear from a variety of sources, the U.S. housing market in recent years has experienced some of the strongest growth in our history. That unprecedented growth is now slowing significantly as indicated by a variety of indicators:

- Housing starts are down from the January 2006 peak and are the lowest since November 2004
- New and Existing Home Sales have declined over the past year
- Mortgage applications to purchase homes are down over 23% from the 2005 peak.

It is anticipated that this weakening of the housing market will continue for the near future. While the strength of the housing market in recent years has been a tremendous boon to individual Americans and the overall economy, the current weakening of the housing market reemphasizes the need to put safeguards in place now to deal with possible housing market developments.

Improving the ability of the federal regulator to oversee the housing-GSEs is one step that Congress is very close to accomplishing, and we urge that the final steps be taken to enact this needed reform legislation.

Failure to pass GSE regulatory reform legislation this year would limit OFHEO's ability to deal with potential safety and soundness matters at the GSEs, which could become serious, if the weakening of the housing market is worse than most currently expect.

OFHEO currently lacks some of the fundamental safety and soundness regulatory authority that other financial services regulators have long possessed. For example, unlike the federal banking agencies, OHFEO lacks the authority to adjust capital for the GSEs to address safety and soundness problems. OFHEO must rely upon its cease and desist powers to force adjustments in capital. Those cease and desist powers also are more limited than the powers Congress has granted to the federal banking agencies. Congress has given the federal banking agencies the authority to bring cease and desist actions against any officer, employee or consultant of a bank for a violation of any law or regulation. OFHEO, on the other hand, cannot issue a cease and desist order to an employee or a consultant of a GSE, and may only issue such an order when certain laws and regulations are violated. Furthermore, because OFHEO is subject to the Congressional appropriations process, the agency has often lacked the resources necessary to properly review the activities of the GSEs. No federal banking agency is subject to the Congressional appropriations process.

We believe that remaining issues regarding the appropriate authority for the regulator can be addressed. For example, on the issue of regulating the size of retained mortgage portfolios of the GSEs, the new regulator clearly needs the ability to adjust the portfolios of the GSEs to reflect the needs of the housing market and potential systemic economic risks.

Improving the regulatory oversight of the housing-GSEs would strengthen the foundation for our housing finance system. Congress is very close to achieving this goal and should complete it this year. Creating a strong, independent regulator with authority comparable to other federal financial services regulators is long-overdue and much needed for the future of our housing finance system.

Thank you for considering our views.

With best wishes,

JOHN H. DALTON,
President, Housing Policy Council.