

## How Housing Policy Hurts the Middle Class

*Many buyers decided that the largest-possible house was a better idea than a retirement fund or a child's education.*

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March 6, 2014

The American dream traditionally meant that anyone could get ahead based on ability and hard work. But over the past few decades, the United States government created incentives through housing programs and the tax code that changed the dream for many Americans. Middle-class families began to think of homes as investments, not just shelter. When the housing market crashed, everyone suffered—homeowners, investors, wage-earners and taxpayers.

Aggressive housing programs have not always helped the poor and middle class. The median net worth of American adults is now one of the lowest among developed nations—less than \$45,000, according to the Credit Suisse Global Wealth Databook. That compares with approximately \$220,000 in Australia, \$142,000 in France and \$54,000 in Greece. Almost a third of American adults have a net worth of less than \$10,000. Those statistics don't convey the pain endured by millions of American families who lost their homes.



As recently as 1980, government-sponsored Fannie Mae and Freddie Mac held, guaranteed or securitized fewer than 10% of U.S. mortgages or less than \$100 billion. Today, it's \$4.7 trillion. Add Ginnie Mae's mortgage guarantees, and the number exceeds \$6 trillion. Since 2008, these agencies have been involved in more than 95% of all new mortgages. This massive exposure has been justified by clichés: Housing should be affordable; ownership creates financial independence; government programs sustain the economy

by increasing ownership. But did ownership increase?

According to the Census Bureau, 65.6% of households owned a home in 1980. More than three decades and trillions of dollars later, the needle hasn't budged—it's still about 65%. Subsidized mortgages did create three things, none of them good:

1. *The largest housing price bubble in American history.* Research by Nobel economist Robert Shiller shows that U.S. housing prices declined in about half of the years since 1890. While U.S. stocks during those years enjoyed an average real rate of return of about 6% a year, the annual inflation-adjusted return on houses was a meager 0.18%. Factor in real estate's heavy transaction costs and that number turns negative. Nevertheless, in the housing-boom decade before 2007, many buyers decided that the largest-possible house (with an equally large mortgage) was a better idea than a retirement fund or their children's education.

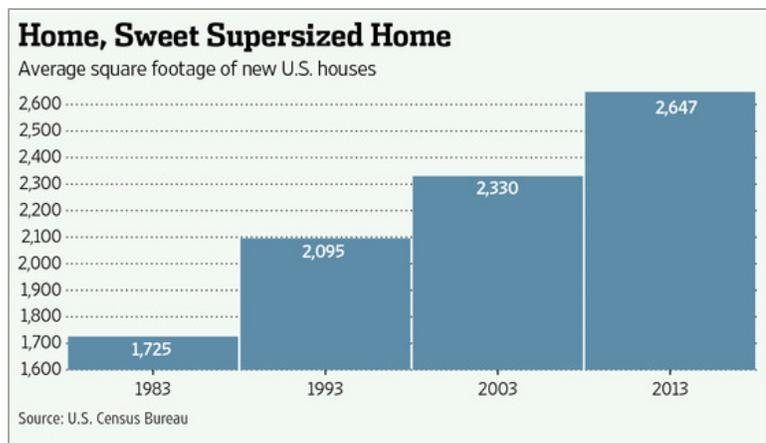
By contrast, according to CLSA Asia-Pacific Markets, middle-class households in 11 Asian nations spend an average 15% of income on supplemental education for their children—nearly as much as the 16% spent on housing and transportation combined. Americans spend only 2% on supplemental education and 50% on housing and transportation. For American home buyers taking on big loans, there was no margin for error if they lost their job or the roof leaked.

*2. Misguided economic priorities.* Uniquely among nations, the U.S. gives mortgage borrowers a trifecta of benefits: extensive tax advantages, no recourse against the borrowers' nonresidential assets if they walk away, and typically no protection for the lender if the borrower prepays the loan to get a lower rate.

These policies long seemed like a great deal for borrowers, but they wreaked havoc on the financial system. People with marginal credit were encouraged to finance more than 90% of the purchase price with 30-year mortgages. If interest rates later fell, they could refinance. If rates rose, they could congratulate themselves for locking in a low rate. If prices rose, they enjoyed all the upside and could tap the equity. If prices fell and they faced foreclosure, their other assets were protected because the loans were usually non-recourse.

The Consumer Financial Protection Bureau now wants to tip the scale even more against lenders by asserting the legal theory of "disparate impact." Consumers can sue if the volume of loans to any racial group or aggrieved class differs substantially from loans to other groups. No intent to discriminate is required, and it's illegal for a mortgage application to ask the borrower's race. Financial institutions trying to avoid making bad loans by implementing prudent underwriting practices can inadvertently get in trouble. A bank forced to pay a fine one year because it irresponsibly made "predatory" loans to people with bad credit can be fined the next year for not making similar loans.

*3. Damage to the environment and public health.* As the nearby chart indicates, the size of the average American house grew by more than half—about 900 additional square feet—over the past three decades while the number of people in the average house decreased. Larger houses need larger lots that are usually farther from the home owner's job. Construction, heating, cooling, landscaping and extended commutes consume more natural resources. Because breadwinners spend more time in cars, they have less time for their families.



As someone who helped finance several of the nation's leading residential builders, I understand the important role the industry plays in the economy. Homebuilders didn't create the problems. Policies made in Washington distorted the banking system and discouraged personal responsibility by

subsidizing loans that borrowers couldn't otherwise afford. This encouraged housing speculation supported by financial leverage. Ultimately, taxpayers got the bill.

Housing's 2008 collapse led to the U.S. Treasury takeover of Fannie's and Freddie's obligations even as the Federal Housing Administration increased its guarantees to more than \$1 trillion and the Federal Reserve stepped up purchases of mortgage-backed securities. Federal debt surged.

Americans will eventually have to pay for that through some combination of inflation, higher taxes, higher interest rates or reduced benefits and services. For now, the Fed is doing what the savings and loan industry did in the 1980s: borrowing short term while lending long term. When interest rates rise, the value of the government's mortgage holdings will decline.

Many housing experts believe that the solution is to reduce the government's role by attracting private capital. That's the centerpiece of proposals presented to the Senate Banking Committee last fall by Phillip Swagel, a senior fellow at the Milken Institute's Center for Financial Markets. Rather than hold or securitize mortgages, Fannie and Freddie would retain only a limited role as secondary guarantors. With the government as a backstop and private capital risking the first loss, mortgage interest rates would undoubtedly rise. But the taxpayer subsidy would fall. It's a reasonable tradeoff to transfer risk from taxpayers to investors and let the market determine rates. Congress appears to be moving in that direction as it debates various proposals.

Fortunately, the private sector is well-positioned to assume much of the government's role. Thanks to booming capital markets and accommodative central banks, there is tremendous liquidity worldwide. Fannie and Freddie have now paid the Treasury more in dividends than they received in the bailout. Private capital already plays a substantial role in commercial real estate and has the capacity to make comparable residential commitments.

Investments in quality education and improved health will do more to accelerate economic growth than excessive housing incentives. That will give everyone a better chance to achieve the real American dream.

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