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THE HOUSING DECLINE: EXTENT OF THE PROBLEM AND POTENTIAL REMEDIES

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BEFORE THE

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THE HOUSING DECLINE: EXTENT OF THE PROBLEM AND POTENTIAL REMEDIES

THURSDAY, DECEMBER 13, 2007

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:10 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Bingaman, Stabenow, Salazar, Bunning, and Crapo.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

In the 1940 film, "The Grapes of Wrath," Ma Joad explained how life had changed. She said, "I've never had my house pushed over before, never had my family stuck out on the road, never had to lose everything I had in life." But that's the threat hanging over millions of Americans today. The fear that their lives are about to fall over. They fear that they will be stuck out on the road. They fear that they may lose everything that they have in life.

According to the Center for Responsible Lending, 2 million Americans will go to bed tonight in fear of losing their homes because their mortgage payments are about to jump. I am talking about people like Luke and Jennifer St. Claire. Luke and Jennifer are a hardworking couple, raising a family in Missoula, MT. They have three kids and number four is on the way. Luke has been blessed. He works as a union bricklayer and earns $23 an hour. That is twice what they call a "living wage" in Missoula. It ought to be enough to raise a family.

But in 2 months, Luke and Jennifer's mortgage will reset. Their monthly payment will jump from $1,400 a month to $1,800 a month, a 29-percent increase. At the same time, everyday expenses like food, gas, and utilities are also on the rise. Over the last 4 years, the cost of living in Montana has increased twice as fast as wages.

Good, hardworking people are in danger of being thrown out of their homes, and we need to do everything that we can to prevent it. Owning one's home is a foundation of the American dream. Home ownership builds wealth. Homeowners feel connected to their communities. But if home ownership is a sure sign of success, what happened this last year? Home ownership rates were the highest in our Nation's history, and housing prices were increasing at the highest rate in our Nation's history.

It turns out that the housing boom was built on a foundation of low interest rates and exotic mortgages. Falling housing prices exposed the underlying weaknesses of the loans themselves, and then the housing market collapsed. Many homeowners who purchased exotic mortgages will see a 30-percent increase in payments, and low teaser rates are adjusting upwards and most of these borrowers cannot afford that kind of an increase.

The housing market makes up 5 percent of the American economy. The housing market is worth $13 trillion. Holders of mortgage-based assets are looking at losses of $100 to $400 billion. Today the overall economy is still strong, but housing troubles have spilled over into the financial markets. Combined with high oil prices, these disruptions could bring a recession. Experts believe that the problem will get worse before it gets better; therefore, we need to find out how to help people keep their homes.

One step that we can take is to address the unexpected tax consequences triggered by foreclosures and loan modifications. The tax code treats forgiven debt as taxable income. The tax code does not tax loan proceeds as income because the borrower pays the loan back. But when the borrower does not pay back the loan, the money looks more like income. In those cases, the code treats it like income. That is sound tax policy. But when so many homeowners are losing their homes and face a large tax bill to boot, it is time for us to provide temporary relief.

Home ownership is the number-one asset class and the number-one wealth builder for Americans. It is the bedrock of the American dream. So let me begin this hearing by asking everyone to work together to achieve the goal of helping Luke and Jennifer St. Claire and the 2 million people like them keep their homes. Let us find ways to keep their house from being pushed over, let us find ways to keep them from being stuck out on the road, let us find ways to help them hold onto whatever they have in life.

Before we turn to the witnesses, I want to take a moment to note that if and when we get a quorum—clearly we do not have one now—we will interrupt to report out four nominations, and they will be Christopher Padilla, to be Under Secretary of Commerce for International Trade; Benjamin Sasse, to be Assistant Secretary of HHS for Planning and Evaluation; Christina Pearson, to be Assistant Secretary of HHS for Public Affairs; and Charles Millard, to be Director of the Pension Benefit Guaranty Corporation.

I have a longer statement on these nominations and ask consent that it be placed in the record at this point. Without objection, it will be included.

[The prepared statement of Chairman Baucus appears in the appendix.]

The CHAIRMAN. I say to all Senators and witnesses, you are on notice that, if and when we get a quorum, that would be 11 Senators, then we will interrupt to report out those nominees.

I would now like to introduce the panel. The first witness is no stranger to this committee or to this city, Secretary Jack Kemp. He is former Housing and Urban Development Secretary in the first Bush administration. I look forward to your views, Mr. Secretary, and the insight that you will have on the housing markets, and I'm sure you will offer some ideas to address the problem based upon your prior service, and also your experience.

We will also hear from Michael Decker, Senior Managing Director for Research and Public Policy at The Securities Industry and Financial Markets Association, otherwise known as SIFMA, which represents interests of security firms, banks, and asset managers.

We will then hear from Dr. Morris Davis. Dr. Davis joins us from Wisconsin, where he is an assistant professor in the Department of Real Estate, School of Business. From 2002 to 2006, he worked as an economist at the Federal Reserve Board.

Finally, we will hear from Ms. Deborah Geier, a tax professor at Cleveland-Marshall College of Law, Cleveland State University. She has written extensively on tax issues, including forgiveness of debt income, depreciation deductions, estate tax, and property transfers between spouses.

Thank you all for coming. I know you have written statements, and they will automatically be included in the record. I encourage you to keep your oral testimony to 5 minutes.

Mr. Secretary?

STATEMENT OF HON. JACK KEMP, PRINCIPAL, KEMP PARTNERS, WASHINGTON, DC

Secretary KEMP. Thank you. Well, at the risk of damaging your Democratic credentials, Mr. Chairman, let me say that Jack Kemp, publicly and privately, agrees with everything you said about Luke and Jennifer St. Claire and the low rates that helped cause the problem, including those exotic mortgages. So, thank you for holding the hearing. Thanks to Chuck Grassley, your ranking minority member. I applaud this effort to bring a perspective on this issue, this crisis, really, before the U.S. Congress and the American people.

This is going to be a historic occasion, because Jack Kemp is going to stick to the 5-minute rule. [Laughter.] I could go 10 minutes without using a verb, Mr. Chairman. [Laughter.]

I very much appreciate you and—I almost said Congressman—Senator Grassley. This is a very serious condition for our American economy and the housing industry. The credit crunch is a great threat to the economy. It certainly is slowing it down. But far from devastating, there are some positive signs in our robust national economy. But nonetheless, it is a crisis if you are about ready to lose a home or you have lost your home through foreclosure.

The subprime mortgage meltdown and the credit crunch, in my opinion, Mr. Chairman, exist because there was, as you said, an over-abundance of liquidity. The Federal Reserve Board, through the FOMC, the Federal Open Market Committee, kept the funds rated 1 percent for far too long.

Now all of a sudden a lurch to 5.25 in 2006 caused, in my opinion, a correlation between the Fed funds rate that was low and the easing of liquidity, and then all of a sudden raising those short-term rates has led to a severe problem, and particularly among adjustable rate mortgage holders in the subprime market, as you pointed out, and also in the private mortgage market.

There were ill-advised subprime loans, particularly, as I suggested, among the ARMs. Along with prime ARMs and subprime ARMs, that represents about 60 percent of the foreclosures.

The impact of the subprime mortgage—I call it a crisis. And incidentally, I think it's interesting that in China the word "crisis" is the juxtaposition of two Chinese characters, one signaling danger and the other signaling opportunity. Yes, there is a danger, but there might be an opportunity to keep Jennifer and Luke in their home. I appreciate the fact that you have suggested that the amount forgiven on a mortgage that, say, has come down from $200 to $150, that should not be taxed as ordinary income. So I strongly support that legislation and believe it is something that both sides of the aisle can support.

The impact of the subprime mortgage contraction is very clear. Lending standards are tightening. Subprime lenders are going out of business or, like Countrywide, refuse to even make loans in the subprime area. The large investment banks have suffered significant losses, and in some cases have gone to the Middle East or to Asia to get infusions of capital investment—witness Citicorp going to Abu Dhabi and UBS going to Singapore.

Most importantly, as you point out, Mr. Chairman, hardworking American families and homes are in jeopardy, because the value of their home in many cases is less than the mortgage.

What can the government do? You pointed out one thing the government can do. I am suggesting that that be included in a 3-pronged approach. Number one, provide mortgage tax relief on a temporary basis so people do not get taxed on loan forgiveness. You stated it quite perfectly. The administration has also proposed allowing cities and States to issue tax-exempt mortgage bonds to refinance existing loans and, under current law, cities and States cannot issue those tax-exempt bonds to finance new mortgages. I think that is a very important step.

We should resist, in my opinion, Mr. Chairman, long-term tinkering with the tax code to address a short-term problem. Our economy is fundamentally strong, although challenges, as I pointed out, are on the horizon. We should not overreact with over-regulation or increasing the tax burden on working and investing Americans. To the contrary. The Federal Reserve Board, in my opinion, needs to continue to value a strong U.S. dollar, but at the same time provide the liquidity to our markets. I was pleased that on December 11 they brought the Fed funds rate down to 4.25 percent. I would have preferred 4.0, because the 10-year rate is 4.1 percent this a.m. I think they should have come down 50 basis points at least.

Second, a limited change to our bankruptcy laws, Mr. Chairman, to help provide relief for distressed homeowners. The House Judiciary Committee passed, yesterday, some important legislation to let bankruptcy judges give the same relief on home mortgages that are already available on commercial real estate loans, vacation home loans, car loans, and other secured debt.

The industry opposes it because they say somehow this will raise interest rates or make credit more expensive, but for decades, Mr. Chairman, bankruptcy courts have been modifying mortgage loans on family farms in chapter 12, commercial real estate in chapter

11, the vacation homes and investor properties in chapter 13, and this has resulted in no ill effects on credit in those submarkets. In my opinion, the bill passed by the Judiciary Committee in the House should now be passed by the full House—the Emergency Home Ownership and Mortgage Equity Protection Act of 2007.

There has to be better scrutiny of lending practices in the rating agencies themselves. I think both were exotic, beyond exotic, in some cases unscrupulous. I applaud the White House and Treasury Secretary Paulson's efforts to encourage mortgage servicers to modify their existing loans for a limited number of borrowers, but we can do more.

I want to get through this. In closing, Mr. Chairman, I think you stated the absolute most pressing need is to help those 2.2 million families avoid losing their homes. We need to keep people in their homes, as I suggested we could do it with some very modest, yet progressive, proactive efforts by the Congress, the Fed, and the White House.

Home ownership is the American dream, but it is also the dream universal. We have had a huge expansion of home ownership opportunities for low-income people. I think 49 percent of people of color have enjoyed home ownership. We need to expand it, not contract it, if we are to remove this gap between those Anglos and people of color in this country. So I thank you for your attention. Thank you for the invitation. I appreciate the opportunity to talk about this issue.

The CHAIRMAN. Thank you, Secretary Kemp.

[The prepared statement of Secretary Kemp appears in the appendix.]

The CHAIRMAN. Dr. Davis, go ahead.

STATEMENT OF PROF. MORRIS A. DAVIS, ASSISTANT PROFESSOR IN REAL ESTATE AND URBAN LAND ECONOMICS, SCHOOL OF BUSINESS, UNIVERSITY OF WISCONSIN–MADISON, MADISON, WI

Prof. DAVIS. Chairman Baucus, Ranking Member Grassley, and members of the committee, thank you for inviting me. I will be referring to the three exhibits at the end of this testimony.

The top panel of Exhibit 1 shows the history of the price of owner-occupied housing, on average, in the United States since 1975. Prior to 1997, after smoothing through the booms and busts, real inflation-adjusted house prices——

The CHAIRMAN. You are on Exhibit 1, is that right?

Prof. DAVIS. Yes. I am sorry.

The CHAIRMAN. Real house prices. Exhibit 1.

Prof. DAVIS. Exhibit 1.

The top panel of Exhibit 1 shows the history of the price of owner-occupied housing, on average, in the United States since 1975. Prior to 1997, after smoothing through the booms and busts, real inflation-adjusted house prices increased by about 0.6 percent per year. From 1997 through mid-year 2006, real house prices increased by 5.7 percent per year. Since 2006, real house prices have been flat.

So, can we explain the recent housing boom? For house prices to rise over time, something about housing must be hard to manufacture. For this reason, it makes sense to visualize a house as a physical structure on some land. Physical structures are like manufactured goods, and so the price of structures should show little upward trend, like the price of most manufactured goods. The dotted line in the bottom panel of your exhibit shows that, in fact, the real price of structures has increased by only 35 percent since 1975.

In contrast, land is not manufacturable and this implies that changes to the demand for housing should be directly reflected in changes to the price of land. Shown by the solid line, the real price of residential land has increased by more than 250 percent since 1975. Viewed in this context, the housing boom experienced over the 1997 to 2006 period was a land boom. Over this period, the real price of land increased by 10 percent per year. A simple statistical model can explain most, but not all, of the recent boom to the price of land, which is the subject of the top panel of your next exhibit.

For most of the sample period, real per capita income, interest rates, and the inflation rate have jointly explained the trend and cycles to the real price of land. To predict the price of land based on these three variables, the dotted line, closely hugs the actual land data, the solid line, until mid-2004, at which point the lines diverge. By last quarter, the actual price of land was 26 percent higher than its predicted price. A 26 percent over-valuation in the price of land currently translates to 12 percent over-valuation in house prices.

The bottom panel of Exhibit 2 lists two possible explanations for why the actual price of land has outpaced the predicted price over the last 3 years. The first explanation is that there is a bubble. There might be some merit to this story, but I would rather focus on the second reason, which is that underwriting standards may have eased in 2004.

A change of this sort is sufficient to cause a surge in the price of land. The reason is that there is a fixed supply of good locations. At any given price level, the number of potential buyers that can afford to live in any given location increases if credit becomes cheaper or more people have access to mortgages. In this case, the price of land must rise to clear the market.

Recently, however, underwriting standards may have become more strict. Thus, at current price levels, the number of potential buyers that can afford to live in any location has fallen. The price of land and housing must fall to clear the market for land. Assuming that underwriting standards have returned to pre-2004 levels, we might expect the price of land and housing to fall by 26 and 12 percent, respectively.

In the final exhibit, I make the case that the decline in house prices will be accompanied by a slow-down in residential investment and GDP. The top panel compares growth in real house prices, the solid line, with the share of GDP accounted for by residential investment, the dotted line.

The correlation of these two series is 86 percent. Thus, if house prices fall, the odds are that residential investment will weaken. In the bottom panel, the solid line shows the percent deviation of real GDP from its trend, and the dotted line shows the percent deviation of real residential investment from its trend. The historical correlation of these two series is 74 percent.

Summing up, given that (A) residential investment is currently below trend; (B) we expect residential investment to fall further as house prices fall; and (C) cycles of residential investment and GDP are highly correlated, from a statistical point of view it seems highly likely that GDP growth will slow.

This concludes my prepared remarks.

The CHAIRMAN. Thank you, Dr. Davis.

[The prepared statement of Professor Davis appears in the appendix.]

The CHAIRMAN. Ms. Geier?

STATEMENT OF PROF. DEBORAH A. GEIER, LEON M. AND GLORIA PLEVIN PROFESSOR OF LAW, CLEVELAND-MARSHALL COLLEGE OF LAW, CLEVELAND STATE UNIVERSITY, CLEVELAND, OH

Prof. GEIER. Good morning. I am pleased to have the opportunity to discuss with you the tax consequences that arise on debt foreclosure or workout pertaining to a principal residence. I will take only a few minutes to highlight my submitted written testimony, and I will be glad to answer any questions that you have for me.

My bottom line thoughts, to summarize right up front, though, are that I believe that the relief provided in the Mortgage Forgiveness Debt Relief Act of 2007, H.R. 3648, passed by the House of Representatives, is justifiable, except that I believe that, at least from a normative or conceptual point of view, the relief should be temporary. Moreover, it would be conceptually defensible to dispense with the basis reduction required by H.R. 3648, though whether or not basis reduction occurs would likely have few real-world tax consequences.

Finally, as a conceptual matter, at least, there is no reason to limit the amount of debt discharge income that could be excluded to $2 million. Let me explain. I think the easiest way to explain is to use a simple hypothetical that I think reflects common facts occurring in our current market situation.

Let us suppose that Tom purchased a primary residence for $5,000 in cash and $195,000 in debt in 2005, resulting in a $200,000 cost basis. When the unpaid principal balance remains $195,000 on his interest-only loan, Tom discovers that the fair market value of his home has been reduced to $170,000 in 2007. He defaults on the debt and the lender forecloses, taking title to the property.

Now, in most instances, for tax purposes Tom's transaction is bifurcated into two component parts. First, Tom is deemed to sell the property for its $170,000 current value, and then, second, he is deemed to use that $170,000 of proceeds to settle the $195,000 outstanding debt.

The first part, the deemed sale, results in a $30,000 loss for tax purposes, but, because a personal residence is deemed a personal use asset, that loss is not deductible for tax purposes.

In the second part of the transaction, the deemed debt settlement will result in $25,000 of debt discharge income if the lender discharges the shortfall—$195,000 debt less the $170,000 repayment—which is excludable under current law only if Tom is insolvent or the discharge occurs in bankruptcy court.

Alternatively, assume the same facts, except that the lender does not foreclose but rather reduces the outstanding $195,000 debt in a workout to $170,000 to reflect its current value. Because there is no property transfer there is no loss calculation, but as before, Tom nevertheless realizes $25,000 of debt discharge income that would be excludable only if Tom is insolvent or in bankruptcy court.

While many taxpayers like Tom are not in fact legally insolvent because of retirement savings that cannot be accessed without stiff tax penalties, they may be functionally insolvent with credit card and mortgage debt exceeding the reduced value of the home and other assets outside of retirement accounts. But they are not legally insolvent and thus they gain no protection from the current insolvency exclusion. These are the taxpayers that would be protected by H.R. 3648.

Now, under H.R. 3648, the solvent taxpayer would be permitted to exclude debt discharge income realized on or after January 1, 2007 with respect to the taxpayer's primary residence, to the extent of $2 million, so long as the discharged debt satisfied the definition of acquisition indebtedness within the meaning of the code provision pertaining to the home mortgage interest deduction. Acquisition indebtedness is debt that is secured by a personal residence and was incurred to acquire, construct, or substantively improve a home, or was debt used to refinance such debt.

Now, H.R. 3648 provides that the amount excluded would reduce the basis of the personal residence only and not any of the other tax attributes listed under current law, such as net operating loss carry-overs and capital loss carry-overs that are reduced if debt is discharged in bankruptcy or insolvency.

But I believe that this basis reduction would not usually result in any actual tax consequences in the future. It would either reduce the amount of non-deductible loss that I described above or, if the debt was discharged in a workout without a transfer, it could conceivably produce gain on a later sale if the home began to regain value over time.

That gain, however, would likely itself be excluded from gross income unrealized under section 121 of the code, which generally allows exclusion of up to $250,000 of realized gain, $500,000 for a married couple filing jointly on home sale gains, so long as the taxpayers owned and resided in the home for at least 2 of the last 5 years.

Now, because H.R. 3648 applies primarily to solvent taxpayers, the real central question here is whether a solvent taxpayer is deserving of any relief. The key to understanding this analysis, in turn, is the treatment of the loss on a deemed sale in the first part of the analysis that I described above. The problem arises here chiefly because personal residences are categorized for tax purposes entirely as personal use assets providing personal consumption.

Wealth used in consumption should not, as a normative matter, at least, reduce the tax base under income tax principles, so losses on sale are not deductible. In contrast, if Tom had bought stock instead of a personal residence with that debt, his $30,000 loss would be deductible because it would represent a wealth reduction that does not reflect personal consumption by him.

Now, in a more normal market for personal residences, this categorization of personal residences as personal use assets that cannot produce deductible losses is generally a good rule. If a home loses value in such a market when most homes at least maintain nominal value, if not appreciate, the reason is usually because the owner failed to maintain the home or made idiosyncratic changes that she liked, but which the market abhorred. That is to say, the value loss is usually due to personal consumption of the taxpayer, just as use of a personal use car which reduces its value reflects personal consumption of the driver.

In that case, the value lost reflects personal consumption and should remain in the taxpayer's tax base. Application of the usual rule results in this treatment. The loss is non-deductible, and the debt, which effectively paid for this personal consumption, results in includable gross income if the debt is discharged and the taxpayer is solvent.

But, in the current unusual market conditions, the value loss of the personal residence does not likely reflect personal consumption of the taxpayer.

The CHAIRMAN. Ms. Geier, I am going to have to ask you to summarize if you could, please.

Prof. GEIER. All right. In an ideal world, I think that we would try to identify those value losses resulting from personal consumption and tax that discharge income arising from them. But, because I do not think that is administratively feasible, I think that the best approach would be to make relief temporary.

These value losses are unusual. When a more normal market returns and most homes maintain value, any loss in value of the home would likely be due to personal consumption of the taxpayer.

Thank you.

The CHAIRMAN. Thanks, Ms. Geier, very much. Thank you.

[The prepared statement of Professor Geier appears in the appendix.]

The CHAIRMAN. Mr. Decker?

STATEMENT OF MICHAEL DECKER, SENIOR MANAGING DIRECTOR, RESEARCH AND PUBLIC POLICY, THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, WASHINGTON, DC

Mr. DECKER. Good morning, Chairman Baucus and other members of the committee. Thank you for the opportunity to testify today about the mortgage securities market and tax proposals to provide relief to homeowners in need. We appreciate the opportunity to work with you and the committee on these issues, just as we continue to work with Banking Committee Chairman Dodd, who introduced comprehensive legislation this week, and Ranking Member Shelby on subprime mortgage reform legislation and related housing matters.

The U.S. system of supplying credit for home buyers has undergone a fundamental transformation over the last 20 years. Mortgage lending has gone from a business dominated by thrifts and other portfolio investors to one dominated by securitization. This transformation has reaped numerous benefits for home buyers, investors, and the economy as a whole. Securitization is responsible for supplying more mortgage credit at a lower cost for U.S. families than would have ever been possible under the old originate-and-hold model.

While millions of families have been able to purchase homes as a result of subprime mortgages and mortgage-backed securities, it has become clear that underwriting standards were at times too loose at the peak of the housing boom. Subprime loans that should not have been made were made.

This happened as a result of a combination of a period of historically low interest rates, overly optimistic assumptions, fraud or abuse on the part of both lenders and borrowers, speculation, and an under-pricing of credit risk brought about by a glut of investment capital from around the world seeking attractive rates of return.

As it became apparent earlier this year that defaults and foreclosures in the subprime mortgage sector were spiking, the market for securities backed by subprime loans changed direction very quickly. Today, the securitization market for new subprime loans has shut down. Virtually no subprime mortgages are being originated, and the values of outstanding securities backed by subprime mortgages have dropped dramatically. Market liquidity, or the ability to seamlessly trade securities in the secondary market, has dried up.

From the perspective of market practices, the downturns in the subprime mortgage market and the credit markets more broadly have raised some challenging questions. For example, how can thinly traded securities—in some cases securities that were never designed to be traded at all—be valued in difficult market conditions? Or how can the market ensure that investors and others have adequate access to information on the structured securities they hold?

SIFMA members and other market participants take these questions seriously, and we are working on solutions that will improve market practices without threatening the benefits of securitization for consumers and the economy as a whole.

From the perspective of public policy, Treasury Secretary Paulson announced last week a multi-pronged plan designed to assist struggling homeowners who will face a mortgage reset with a rising interest rate. A key element of this plan is expanding the use of tax-exempt mortgage revenue bonds to help such homeowners refinance their subprime loans.

Tax-exempt mortgage revenue bonds issued by State and local governments are an important tool to finance low-cost mortgages for low- and moderate-income families. Under current law, MRBs can be used to finance new mortgages for first-time homeowners for owner-occupied single-family homes. Treasury's proposal would allow State and local governments to issue tax-exempt MRBs to refinance existing subprime loans.

As members of this committee explore efficient and flexible solutions for distressed homeowners, tax-exempt bonds can help accomplish that goal. The refinancing of existing loans at lower interest rates remains a preferable outcome for troubled borrowers. We urge the committee's adoption of this proposal.

While policy and market practice responses to the housing decline are important, the fundamental issues of over-supply and over-pricing of residential housing can only resolve themselves through market adjustments. Reducing the inventory of new and existing homes for sale is key to an overall turnaround in housing. Home prices will need to continue to adjust to draw buyers to the market and reduce supply.

At the same time, a de-leveraging and recognition of losses, already begun at banks and securities firms, investment funds, and others affected by the credit downturn, will help alleviate constraints in the supply of credit, as will continued actions by the Fed and other central banks.

The evolution of mortgage securitization has been one of the most remarkable developments in the financial markets over the last 25 years. The mortgage securities market, now the largest sector of the U.S. bond market, has brought benefits to home buyers and has reduced risks for banks, thrifts, and others engaged in home lending. Despite the downturn in the subprime mortgage market and the broader real estate sector, securitization will continue to provide a ready supply of capital for consumers and others.

Thank you again for the opportunity to be here. I look forward to your questions.

[The prepared statement of Mr. Decker appears in the appendix.]

The CHAIRMAN. Thank you all very much.

I would like to focus a little bit more on this committee's jurisdiction, that is, on the tax side. I would like the entire panel's reaction to the House proposal that allows homeowners to exclude cancellation of debt income resulting from either foreclosure or refinancing. So, just quickly.

Secretary KEMP. I strongly supported it in my testimony, Mr. Chairman. I believe it is absolutely essential. I congratulate Senator Stabenow for introducing it in the Senate. I know there is Republican and Democratic support. So I think it should be done, along with one other act that could be passed. That is, reinstating the mortgage insurance tax deduction. It expires December 31, 2007. I think it should be continued as an existing tax deduction for mortgage insurance.

The CHAIRMAN. All right. Dr. Davis? Would you modify the $2 million limit, for example, so it is indefinite in duration? What do you think of it, and would you modify it? That is to Dr. Davis.

Prof. DAVIS. I think, in spirit, it sounds like a good idea. I have not thought about the details, so I am not prepared to give an answer as to all the details and whether or not it makes sense in its current form, or should be modified. But it is good. I think it is the right thing to do.

The CHAIRMAN. Ms. Geier?

Prof. GEIER. I support it. I do think that some changes would be conceptually defensible. Three, really. Number one, this exclusion really does stand on a different footing from the bankruptcy and insolvency exclusions. Those exclusions are in the code because it is thought to properly measure income, but we do not want to tax that income now.

We want to defer taxation until the future when the taxpayer is on a more financially sound footing. So the exclusion is immediate, but the taxpayer must reduce valuable tax attributes in an equal amount so that the idea is that the taxpayer's future income will be increased by precisely the same amount that was excluded this year. So the bankruptcy and insolvency exclusions are not properly thought of as tax forgiveness provisions, they are properly thought of as deferral provisions.

The CHAIRMAN. Right. But I am talking about this one.

Prof. GEIER. So this one, I think, therefore, the House bill has structured it the same way. It requires a basis reduction in the home under the same kind of normative structure as for the bankruptcy and insolvency exclusions, which can require a basis reduction in property which can increase future gain, and therefore future income.

The CHAIRMAN. My real question is, how would you change it? Very, very briefly, because my time is about to be up.

Prof. GEIER. All right. Very briefly, I would make it temporary.

The CHAIRMAN. How temporary?

Prof. GEIER. That is beyond a tax expertise. It is an empirical question. It should be, to the extent we believe the bubble has not burst yet, to the extent we believe home values will——

The CHAIRMAN. All right. Make it temporary.

What else?

Prof. GEIER. I would not require a basis reduction in the principal residence.

The CHAIRMAN. What about the $2 million limit?

Prof. GEIER. The $2 million is not conceptually justifiable. For revenue needs, it may be necessary, but, as a matter of properly measuring income, this should not be thought of as real income. So, therefore, regardless of the amount, it should not be taxed.

The CHAIRMAN. Any limit to owner-occupied, or to a taxpayer who lives in the home, not to investors?

Prof. GEIER. Yes. I do believe that H.R. 3648 is limited to the taxpayer's primary residence.

The CHAIRMAN. Right.

Prof. GEIER. And it also does not allow exclusion of home equity debt, to the extent that it was used in a way other than to permanently improve the home. I think that is correct as well.

The CHAIRMAN. Mr. Decker, your thoughts?

Mr. DECKER. We think that the concept of excusing forgiven mortgage debt from taxation is a good one and will help servicers and lenders keep families in homes. With respect to the House bill specifically, I think that the permanence of the House provision is probably not appropriate in the context of the current market conditions. Sunsetting the provision after 2 years, maybe, would give Congress the chance to revisit the proposal in the context of whatever market or mortgage conditions were prevailing at the time.

The CHAIRMAN. I have another question, and that is the degree to which the seizing up of the credit markets is having a separate effect, maybe adverse effect, on homeowners. We have been looking at the subprime problem with the administration's proposal and other refinancing, and so forth, to help the home buyers, to help homeowners as we are in discussing this legislation, but in addition—I am just curious of your reaction—the degree to which tightening up of the credit markets—today's papers, for example, central banks are trying to get more money in banks so they start to trust each other more. The banks trust each other more and start lending to each other a little more. To the degree they are not doing that, how much of an adverse effect does that have on my Montana St. Claires? If it is having an adverse effect, what should we do about that as a Congress? Mr. Secretary?

Secretary KEMP. Well, I pointed out in my testimony, Mr. Chairman, that the Congress is proactive. The administration is proactive, albeit in a very modest fashion. I think the Fed has to be more proactive. I have called for a 50 basis point reduction to 4 percent. The 10-year T-bill is 4.1. There is an inverse yield curve. I think that has to be resolved, and it can only be resolved by lowering the Fed funds rate to 4.

Now, in my opinion, there is a correlation—maybe not a perfect correlation—but I think Chairman Greenspan kept the Fed funds rate too low for too long. It was too much liquidity, it had a huge impact on housing values and real estate values, and all of a sudden to go from a 1-percent Fed funds rate set by the FOMC to 5.25, it affected adversely all those ARMs, both in the subprime market and in the prime adjustable rate mortgage market.

The CHAIRMAN. Thank you.

Senator Bingaman, you are next.

Senator BINGAMAN. Thank you very much.

Let me ask you, Dr. Davis. As I understand your testimony, you are saying that residential investment is going to continue to fall as housing prices continue to fall and that that will result in a lowering of Gross Domestic Product going forward.

Prof. DAVIS. Yes. There are two pieces to that. I had another exhibit prepared for the committee, but in the interest of keeping to the 5 minutes I did not show it. So there are two pieces. The first is, there is an arithmetic lowering. Residential investment is a component of GDP, so, to the extent that there is a reduction in residential investment, there is an arithmetic reduction in GDP. Recently the slow-down in residential investment has arithmetically caused a 1-percent reduction in what we would have seen to GDP, and that data is available at the Bureau of Economic Analysis.

So that residential investment has an arithmetic pull on GDP, and then there are the economic forces at work. So the economic link between house prices and GDP is through this consumer spending channel called the "wealth effect." What the wealth effect says, briefly, is that when people are less wealthy they spend less on consumption.

Typical estimates are that, for every dollar reduction that households' balance sheets fall, for every dollar, consumer spending falls between 3.5 and 5.5 cents to the dollar. So in Exhibit 3, you saw a statistical link between residential investment, house prices, and GDP. What I have just presented to you now is an economic link: house prices fall, people are less wealthy, they spend less on consumption. As residential investment falls, arithmetically that pulls down GDP.

Senator BINGAMAN. Are you able to look ahead? We are beginning 2008 here in a few weeks. Are you able to look ahead and say what the time frame for some of this will be? I have heard predictions that the price of housing is likely to bottom out in 2009 sometime. Are we looking at a continued decline in GDP until that time or do you think that there is no way to predict?

Prof. DAVIS. There are two parts to this answer. Let me first refer you to Exhibit 1, if you would not mind. In the past, the downturns in house prices—and you would know there was a downturn by looking at the black line, and when the black line falls there is a downturn—have lasted about 4 years. So if we were to think that going forward will look like the past, we might expect another 2 to 3 years of house price declines.

The impact that will have on GDP. In the minutes of the Federal Open Market Committee, it looks like the economists in the central bank and the branch banks think that, if I am reading the forecasts accurately, there will certainly be a slow-down in 2008, a slow-down relative to GDP's normal rate of growth, which is 3 percent. So, the forecast in the FOMC minutes is between 1.8 and 2.5 percent. In 2009, there might also be a slow-down as well.

Senator BINGAMAN. A further slow-down from 1.8?

Prof. DAVIS. No, no. From trend. So if trend is 3 percent, 2008 might be 2 percent, 2009 might be 2.3, 2.5 percent.

Senator BINGAMAN. All right.

Prof. DAVIS. So house prices 4 years, GDP, 1 to 2 years.

Senator BINGAMAN. Let me ask Mr. Decker, what about the secondary market for new home mortgages? Does that come back?

Mr. DECKER. There are elements of it that never really slowed much. The market for conforming loans, loans that are eligible to be bought by Fannie Mae, Freddie Mac, and Ginnie Mae, is still robust and has been robust through the downturn. The market for non-conforming loans, including subprime loans, slowed considerably earlier this year.

There is now credit available for non-conforming prime loans—so, loans that are not eligible for Fannie Mae or Freddie Mac purchase, but where the borrower has good credit or there are low loan-to-value ratios. There is practically no subprime lending taking place right now.

Senator BINGAMAN. But those non-conforming prime loans, are those being securitized?

Mr. DECKER. In some cases they are. In some cases they are being held in portfolio.

Senator BINGAMAN. What about this problem of the larger loans that are above $417,000? What about that? Is there a secondary market for those loans?

Mr. DECKER. There is a secondary market. It is not as liquid or robust as it was even 6 months ago. The best indication is the difference in mortgage rates between conforming loans and non-conforming prime loans, which is now something like a percentage point, which is much wider than it typically is in normal market conditions.

Senator BINGAMAN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

Professor Davis, in your testimony you assume that underwriting standards have returned to the pre-2004 level. But is it not more likely that underwriting standards will become even more strict than in 2003 to reflect the added risk that banks and investors now appreciate better?

According to your analysis, that seems to increase the risk of a recession even further. Would you say that the Federal Reserve, under former Chairman Greenspan, should have intervened sooner to tighten underwriting standards? Alan was trying to get all of us here at the table to take ARMs at the time. He thought that would be a good buy for everybody who was purchasing homes at the time. Would we be here today if the Fed had intervened earlier?

Prof. DAVIS. Let me address both parts of that question separately. The first is, I did not mean to be optimistic or pessimistic in my testimony. I just said if underwriting standards revert to pre-2004 levels, then here is a forecast for how much house prices will fall. Certainly if credit conditions become more strict prior to 2004, then it is reasonable to assume house prices will fall by even more.

Then with respect to what the Federal Reserve should or should not do, there is one statistic that I find telling. This is in the GAO report on, I think, October 16 to the House committee. In 2006, of the top 25 originators of subprime and Alt-A, which is 90 percent of volume, 21 were non-bank.

Senator BUNNING. But that did not make any difference because the Federal Reserve had control over banks and non-banks.

Prof. DAVIS. All right. Then there is the other quote from Mr. Bernanke that, according to Home Mortgage Disclosure Act data, “lenders not subject to oversight by Federal banking agencies originated just under half of higher-priced conventional first-time mortgage loans in 2006.”

Senator BUNNING. Yes, sir. I understood that. I questioned Chairman Bernanke when he was before our committee about that.

Prof. DAVIS. So the Federal Reserve—I do not want to criticize what they did because I——

Senator BUNNING. I sure do.

Prof. DAVIS. Their mandate is to follow unemployment and inflation.

Senator BUNNING. Thank you very much.

Secretary Kemp, you said in your testimony that Congress should provide relief so that people do not get taxed on loan forgiveness. But later on in your testimony you refer to this idea as “tinkering.”

Secretary KEMP. I do not think I did.

Senator BUNNING. Well, I am pretty good at——

Secretary KEMP. I am sure I did not mean to.

Senator BUNNING. It is in your written testimony.

Secretary KEMP. It may be, but I apologize if it is in there. It should not be. I summarized and I made it very clear that I support the legislation to provide mortgage relief from ordinary income.

Senator BUNNING. All right. Let me just follow up then. If it is good policy today, why not make it permanent?

Secretary KEMP. It may be that you should. I did not talk about that. I supported the Stabenow bill. There should perhaps be a sunset restriction.

Senator BUNNING. I happen to agree with that. I happen to agree that there should be a sunset provision.

Secretary KEMP. All right. Good. Then we are agreed.

Senator BUNNING. Back to Professor Davis. You used the "wealth effect" in your testimony also. Chairman Greenspan used the "wealth effect" to pop the bubble on the tech bubble that he talked about quite a while back. He talked about the wealth effect and people having more money to spend, and therefore we were going to have this huge bubble. He never, ever mentioned it during the housing bubble, which happened to be popped after he had left it on the table for Chairman Bernanke.

Prof. DAVIS. Right.

Senator BUNNING. I just wanted you to know that was the case.

I had another question for Professor Geier, but I do not know if I have enough time. I happen to think that H.R. 3648, on a temporary basis, would be a fine start. I also happen to think that the administration is a little timid in their approach. But that is not unusual. They want to get things started and obviously let us carry the ball. That is usually their way of doing things.

I think it is a temporary change that should be made, as you do. Most of the panel, I believe, thinks it should be temporary. We hope that Senator Stabenow's legislation will be considered by this committee as we go down the pike.

Thank you very much.

The CHAIRMAN. Thank you, Senator.

Senator Salazar?

Senator SALAZAR. Thank you very much, Chairman Baucus, for holding this hearing on this very important issue this morning. In Denver, CO, Denver wakes up to yet another headline which I think is typical for the rest of the country. The headline in this morning's *Denver Post* is, "Colorado Foreclosures Set Record." The first line—I will not read it all—is "More Colorado homeowners have gone into foreclosure in the first 9 months of this year than in all of 2006, which was a record year."

In conversations that I have had with home builders and others who are interested in this issue in my State of Colorado, not only do they see us as being one of the top five States that is being affected by the home foreclosure problem, but they also do not think we have yet seen the worst of it, that the worst of it is coming. We will see that as the ARMs on mortgages are adjusted in the year ahead. So the next couple of years, I think, are still seen as being very problematical from the point of view of people whom I have talked to.

Mr. Chairman, I have a longer statement for the record that I would just submit for the record, if there is no objection.

The CHAIRMAN. Without objection.

[The prepared statement of Senator Salazar appears in the appendix.]

Senator SALAZAR. Now I have two questions, or maybe three questions. The first one I think you have answered in terms of answering Chairman Baucus's questions relative to loan forgiveness and how we would deal with that in terms of the tax consequences of that. I do hope, Chairman Baucus, that we are able to move forward with some proposal, whether it is Senator Stabenow's proposal or ideas that you might have, because I think that is one avenue in which we can be helpful.

The second—and here I want some of you with expertise on this to respond back—some have suggested that we do something with private activity bonds. The White House has suggested that we do something with respect to private activity bonds in the mortgage market. What I would like to do is get your thoughts on what it is specifically that we have to do with respect to private activity bonds for mortgages.

Secretary Kemp, I can start with you and we can just come this way. If you will keep your answers relatively short, we will make it all the way to this end before my 5 minutes are up.

Secretary KEMP. Well, Senator, thank you for the question. I agree with you, it should be both private and public. The more we can have MRBs, tax-exempt mortgage bonds, both public and private, the better off we would be in this very troubling and vexatious moment in the history of the housing market.

Senator SALAZAR. Do you have a suggestion as to how much of a private activity bond increase we ought to make to deal with the problem?

Secretary KEMP. No, I really would not. I usually have an answer for everything, but not that.

Senator SALAZAR. All right.

Dr. Davis?

Prof. DAVIS. I am sorry. I do not have anything useful to add.

Senator Salazar.

Professor Geier?

Prof. GEIER. I think our colleague here is the one who is going to have the most relevant answer to that. But the tax consequences on the back end are not going to help all of the homeowners now who are going to see those rate increases. As I understand it, the private activity bonds or mortgage refinancing bond proceeds could be used to help refinance those taxpayers' loans to keep them out of ever having to seek relief under the tax provisions that the committee is considering.

Senator SALAZAR. All right.

Prof. GEIER. So, I think it is a good idea.

Senator SALAZAR. Mr. Decker, they are not mutually exclusive approaches to dealing with the issue?

Mr. DECKER. No, not at all. The Treasury proposal is a smart idea. Mortgage revenue bonds provide below-market rate financing for low- and middle-income home buyers, but right now State and local governments can only use them for new home purchases.

So allowing those bonds to be used for refinancings of subprime borrowers who are in trouble would give them another opportunity to potentially stay in their homes. The one issue that comes up when you talk about expanding mortgage revenue bonds is the existing volume cap that applies to all private activity bonds, which might constrain the use of the Treasury proposal. So, that is one amendment you might want to think about.

Senator SALAZAR. So it would be something that we would have to consider here in this committee if we are going to move forward with that.

To whoever wants to take this question, I have about a minute left. Is there a difference in terms of how this home foreclosure problem is affecting rural America versus the urban parts of America, or is it the same in both places?

Secretary KEMP. I am sure there is an answer to that. I do not have a geographical distribution of the problem. I alluded earlier in my testimony to the fact that over 60 percent of all the foreclosures are in the ARMs, the adjustable rate mortgages, both in the subprime and in the prime market. About 45 percent of it is in the subprime, about 15 to 20 in the prime market. So I am sure it affects rural and urban America probably in a parallel fashion. It is a threat to both sides of this distribution of our income.

Senator SALAZAR. Does anybody else have any other information on that question? [No response]. All right.

Thank you very much, Chairman Baucus.

The CHAIRMAN. Thank you, Senator.

Senator Stabenow?

Senator STABENOW. Thank you very much, Mr. Chairman, for this hearing. This is such an important topic. Thank you to all of you. It is good to see you.

We are all looking, on our committee and the Banking Committee, working with the administration as well, at what we can do.

I guess the first question that I would have relates to what you have been talking about in terms of the mortgage tax cancellation legislation which I have introduced with Senator Voinovich and a bipartisan group, and there is a bill that has passed the House, as you know. The House bill is permanent. Those of us in the Senate would like to make it temporary. We may be in a situation, with the interest of time now, to get something on the books and clarify it as we go forward.

But would you agree that it is critically important to get something in place for this year? I mean, I am certainly hearing at home—I think I am asked about this almost as much as anything now in terms of people who are in a situation of foreclosure, short sale, refinancing, but find themselves not only having a hardship, maybe losing their home, but maybe having a new tax bill. So would you agree with the sense of urgency that we address this this year?

Secretary KEMP. Absolutely. I think the Chairman began, Senator, by alluding to your bill. I think all of us, to one degree or another, agree that it should be passed as immediately as possible. It passed the House. I think it should be sunsetted, but that would be up to the wisdom of the Senate and the House conference.

Prof. GEIER. One thing that I did not get a chance to mention, but is in my written testimony, is that the effective date of H.R. 3648 is for debt forgiveness income that arises after January 1, 2007. One of the things I mentioned in my written testimony is that I do think that, if in fact there were substantial foreclosures due to falling home prices in 2006, that it would be justifiable to even make it retroactive before then. If this is not conceptually income, it should not be taxed whenever it rises.

Senator STABENOW. Right. Thank you.

Thank you, Mr. Chairman, for mentioning the bill. I know you are leading our efforts to address this.

On a little different topic, in the sense of what we ought to be doing, I know that the administration has preferred a 1-800 number, I know the mortgage bankers—we were at a U.S. Conference of Mayors meeting where I participated on this issue a couple of weeks ago in Detroit, and indicated they are putting forward resources, and also a database on their website so that people can find out who actually holds the loan, since these days it is not just going back to your lender, you are trying to figure out who you talked to, who holds the loan.

But we also have dollars in the budget, $200 million, that we have passed for counseling to be able to help people sort through these things. Is that an important piece? I may have missed this. I apologize if I was not in the room.

Has anyone mentioned the extent to which individually, now, being able to help people sort out who has their mortgage, what are the options, do they fit under what the President announced or not? Unfortunately, most folks in Michigan do not because they are not current on their payments and are not in a situation to take advantage of it. But we want people to be able to be helped and not be placed into a situation where, in fact, they go into foreclosure.

Secretary KEMP. I alluded to that in my testimony, Madam Senator. The Chairman alluded to it earlier as well. I also mentioned a limited change to our bankruptcy laws to provide relief for distressed homeowners. We provide that type of relief for real estate loans, vacation home loans, car loans, and other secured debt, so I think it should be also—it passed yesterday in the House Judiciary Committee. It seems to me it would be a limited change to our bankruptcy laws that would be quite progressive.

The CHAIRMAN. I might ask, if the Senator would yield.

Senator STABENOW. Yes.

The CHAIRMAN. I could never understand why there is that distinction in the law.

Secretary KEMP. It was changed in 1978. I was in the Congress. I went back and looked at it and it passed by voice vote. So how did I vote? It passed by a voice vote. I do not even remember what I did. I wish I had spoken up then because I think it is a ridiculous——

The CHAIRMAN. I did, too. I just wondered about the origin of all that, and I was just curious as to if you knew.

Sorry, Senator. Go ahead.

Secretary KEMP. One last point, Mr. Chairman, to Senator Stabenow. I mentioned also the mortgage insurance tax deduction expires.

Senator STABENOW. Yes.

Secretary KEMP. I would like to see that renewed. I want to submit for the record, I was watching Kudlow and Company on—I forget. I had better be careful here, with the battle between the cable shows. But Kudlow had a very interesting chart on where the problem is among the ARMs, prime and subprime, and the Fed funds rate from 2002 and 2005, and suddenly going from 1 percent to 5.25 percent and what that did to those ARMs.

Senator STABENOW. Right. Right.

Secretary KEMP. And 60 percent of the foreclosures are in the prime and subprime ARM market. I would just like to submit it to the Chairman's staff for the record.

The CHAIRMAN. Without objection.

[The information appears in the appendix on p. 52.]

Senator STABENOW. Thank you.

Just in closing, I would say what we know also from testimony is that most of those are coming due, those resets are. We have not even seen all of them, or begun to see them yet, so we have a lot to do on it. I know we are working on FHA reform and the tax piece, and bonding authority, and a number of things, but it should have, certainly, our highest urgency.

Mr. Chairman, thank you for that.

The CHAIRMAN. Thank you, Senator, very much. I appreciate your legislation.

I am just curious. At what point will confidence come back? That is, when will we hit bottom? What is it going to take? Does it take policymakers to show greater recognition of the problem and being more candid about it and being recognized realistically, the excess underwriting standards, maybe purchasers? Perhaps we are a little bit too forward-leaning in getting our mortgages in the first place, plus all the SIVs, the CDOs, and all the securitization and so forth. But I am just curious as to your thoughts. I am sure it is on the mind of most every American here: when are we going to get out of this mess, what is it going to take, and what are some indicators and what needs to be done so we know we are starting to go forward?

Secretary KEMP. Let me take a stab at it. I have to leave, and I apologize to your fellow committee members and you, Mr. Chairman, for having to leave. I did not realize that we would go beyond 11 o'clock. But just a stab from a 60,000-foot view.

The CHAIRMAN. Sure.

Secretary KEMP. I think the fact that there is a proactive Congress, legislation we discussed, including counseling, a proactive administration, albeit it is modest, as the Senator from Kentucky pointed out, and a proactive Fed. The Fed is more proactive. I criticized it earlier for not going down a full 50 basis points. The spread between overnight money in 10 years is ridiculously inverted. You can borrow 10 years at 10.1, and overnight at 4.25. So, I thought it should have come down to 4.

I think, in order to keep the dollar strong—this would be Jack Kemp saying this; I do not speak for anybody else—I think we should cut the corporate income tax rate. We have the highest in the world. It would increase the demand for the dollar, thus it would help strengthen this move by the Fed that some would suggest might set off incipient stages of inflation.

So a proactive Fed, a proactive Congress, and a proactive administration are steps in the right direction. I do not foresee a recession. I think there will be a slow-down. I think we should take steps to forestall any fear of recession by bringing those tax rates down, and interest rates.

The CHAIRMAN. Other comments? I have only about 2½ minutes left. Do other panelists have a reaction to that? Mr. Decker?

Secretary KEMP. Thank you, Mr. Chairman.

The CHAIRMAN. Yes. Thank you, Mr. Secretary, for coming. We deeply appreciate you taking the time. Thank you.

Mr. DECKER. Ultimately, what it will take for the crisis to abate is a repricing of assets. That means a repricing of homes. Home prices will need to continue to fall in order to work through the excess inventory and bring buyers back into the market, and a repricing of financial assets. You see investors and banks and securities firms taking very large write-downs, very large charges against income to mark their portfolios to market. Some investors are more able or willing to do that than others, but eventually, across the board in the capital markets, investors will need to de-leverage, recognize that they have taken losses on their books, and there will be an opportunity for more——

The CHAIRMAN. Let me ask another question. Let us take the public sector. The public sector response, do you think, is about right, or too much, or too little? Secretary Paulson has presented his proposal, his HOPE proposal, for example. He also suggested that States be able to issue revenue bonds. There is talk in the house of FHA and so forth. I frankly think Freddie Mac and Fannie Mae can do more than they are doing. They are talking at the Fed of easing credit up a little bit. Now we in the Congress, here in this committee, are going to help with the cancellation of debt, and so forth.

Do you think, given the moral hazard question, is it about right? Have we gone far enough generally? Too far? Your sense.

Mr. DECKER. I think that the issues that you have raised this morning and that are before this committee, the cancellation of debt proposal and the mortgage revenue bond proposal, are just the kinds of solutions that Congress should be thinking about in the current context. I think the market has welcomed the Fed response for the most part, the change in direction of Fed policy.

Some have argued that it should be more aggressive or faster than it is, but overall the Fed is on a clear path towards easing, which is welcomed by the market. Overall, I think fundamentally for the crisis to resolve itself, it requires more of a market adjustment than a policy adjustment.

The CHAIRMAN. Then in answer to my question, I infer from what you said that you think the public response, the government response, is about right. Or would you change it or modify it in some way while we are waiting for the over-priced houses to start working their way through?

Mr. DECKER. Well, I think that we——

The CHAIRMAN. Do we help people more or not?

Mr. DECKER. I think that, like you said, you run the risk, if you start thinking in terms of bail-out type policy, you run the risk of a moral hazard. I do not think, from a capital markets perspective, anyone is looking for or expecting that kind of response from the public sector.

The CHAIRMAN. What do you say to those people who are losing their homes?

Mr. DECKER. Well, I think that, between the public sector response so far and the securitization of the mortgage industry, some of the steps that have been taken—our affiliate organization, the

American Securitization Forum, has taken very aggressive steps to create a standardized framework for mortgage servicers to be able to sort through the very large volume of loans that are going to be reset in the next 2 years and find ways to process those as quickly as possible; refinance the ones that are possible to refinance, modify the ones that are are possible to modify, to keep as many families in their homes as possible.

Senator STABENOW. Mr. Chairman, might I just insert, you had mentioned Fannie Mae and Freddie Mac. And I could not agree more with the idea, as quasi-governmental entities that were set up just to address these kinds of issues, to be there, to be able to support the housing market, that they could do more. But they are saying they would do more if we allowed them to do that, to be able to raise their limit so they could place more capital into the marketplace.

I would be interested in your reaction to having them be able to participate more. It seems to make a whole lot of sense to me that we would look to them. They are willing to do it. They have a track record, and obviously the expertise to be able to more aggressively help.

Mr. DECKER. Raising the conforming loan limit is one of the issues that has been on the table with respect to Fannie Mae and Freddie Mac, and I think that there are certainly some positives associated with doing that. I think that the conforming mortgage market, the Fannie, Freddie, and Ginnie Mae eligible part of the market, like I said, has remained robust and has remained liquid through the crisis.

The other side of the argument is that the mortgage agencies have a competitive advantage relative to private participants in the market and that expanding their scope creates a disadvantage for private market participants. So I think you have to weigh those kinds of concerns.

Senator STABENOW. Thank you.

The CHAIRMAN. Thank you all very much. Thank you for taking the time to come here.

This will conclude the hearing portion of this session. As for the nominations markup, we have been unable to achieve a quorum of 11 Senators, so the committee will stand in recess until the next vote on the floor of the Senate. We will reconvene off the floor to vote on those nominees. So, in the meantime, thank you again to all witnesses for coming today. I thank the Senators again today.

We are also going to move either the Stabenow bill or something similar to it and try to get that moved very quickly, perhaps today or tomorrow, because people need some help, and we are going to try to do what we can do to accomplish that result.

The committee is in recess until the next vote.

[Whereupon, at 11:20 a.m., the hearing was recessed.]

APPENDIX

Additional Material Submitted for the Record

Nominations
Statement of Senator Max Baucus
December 13, 2007

Mr. Padilla's nomination comes at a pivotal time in U.S. trade policy. Negotiators from the United States and the 150 other members of the World Trade Organization are trying to reach a deal by the end of the year. At the same time, the administration is pushing Congress to approve new trade agreements with Peru, Panama, Colombia, and Korea. And the administration seeks renewed fast-track authority to negotiate even more agreements.

But continued support for trade is dependent upon the United States enforcing the trade agreements that we already have. And support for trade is also dependent on reauthorizing and expanding Trade Adjustment Assistance to make sure that we extend a helping hand to those whom trade leaves behind. It's hard to imagine how we can move ahead on our trade agenda until we meet this critical objective.

The second and third nominations before us today are for the Department of Health and Human Services. HHS is the largest non-defense agency in the Federal Government. It is charged with protecting the health of all Americans. It is charged with providing essential human services, especially for the most vulnerable among us.

The first of the two HHS nominees whom we will consider is Benjamin Sasse to be Assistant Secretary for Planning and Evaluation. This person advises the Secretary of HHS on policy developments in all areas of the Departments' work.

And planning based on that information can have long-term implications. I am concerned that Federal funds are being directed toward research with political objectives, rather than scientific importance. I expect Dr. Sasse to work to craft a research agenda that is politically unbiased and scientifically relevant and accurate. Americans want to have their tax dollars directed toward research that really works to find cures for diseases. Our children and seniors deserve it.

Christina Pearson has been nominated to be the Assistant Secretary of HHS for Public Affairs. This position carries significant responsibility. It's a serious job to manage the Department's public face and translate its policy into digestible messages for the American people.

Americans respect and believe information transmitted by the Secretary. I expect Ms. Pearson to be accurate and factual. I expect her to put politics aside in the conduct of her job. Americans deserve the real deal, not information twisted for political gain. Our nation's health and wellness depend upon it.

Mr. Millard is the first nominee for PBGC Director subject to Senate confirmation. Last year, in enacting the Pension Protection Act, we upgraded the position to a Presidential appointment subject to Senate confirmation, and made it one of the few positions in government subject to confirmation by two committees — Finance and HELP.

The position's new status reflects how important we consider the person responsible for making sure that our workers receive their pensions. And it reflects the great concern by both Committees about the financial health of the PBGC and the defined benefit pension system.

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON FINANCE
"The Housing Decline: The Extent of the Problem and Potential Remedies"
December 13, 2007

Thank you, Mr. Chairman.

I welcome the opportunity to hear from this distinguished panel about the present housing crisis and the Bush Administration's proposals to address the problem.

For most American families, home ownership has been the key to prosperity over the past several decades. Millions of Americans are depending on the equity in their homes to fund their retirement and millions more have tapped into this equity to pay for critical needs, such as unexpected medical expenses.

Congress has had a long-standing policy to encourage home ownership by providing tax benefits that make it easier to afford a home. The three major benefits are: (1) the deduction for mortgage interest on owner-occupied homes; (2) the deduction for property taxes; and (3) the exclusion from income for proceeds on the sale of a principal residence. According to the Joint Committee on Taxation, these benefits amount to over $670 billion in foregone tax revenue every five years. They are the largest tax benefits in the Internal Revenue Code.

In addition, by encouraging securitization of mortgage debt Congress has facilitated the growth of a $2 trillion market for mortgage-backed securities. The collapse of the sub-prime market and the restoration of tighter underwriting standards has led to an unprecedented nationwide double-digit decline in housing prices.

Because so many homeowners are highly leveraged, a small decline in housing values is likely to have a major impact. To the extent that market conditions lead to foreclosure or sale at a level below the principal amount of a loan, the tax laws could create unexpected income tax liability for the homeowner. I'm glad we are looking into this today, and I hope we will also address the Administration's plan to "freeze" mortgage interest rates for certain loans and to provide extra financing capacity to state and local governments to assist with mortgage loan workouts.

I thank the Chairman for holding this timely and important hearing and I look forward to the testimony and discussion today.

Thank you.

Testimony of Morris A. Davis

to the Senate Finance Committee, December 13, 2007

Subject: House Prices and the Macroeconomy

Chairman Baucus, Ranking Member Grassley, and Members of the Committee, thank you for inviting me.

The top panel of Exhibit 1 shows the history of the price of owner-occupied housing, on average in the United States, since 1975. Prior to 1997, after smoothing through the booms and busts, "real" (inflation-adjusted) house prices increased by about 0.6 percent per year. From 1997 through mid-year 2006, real house prices increased by 5.7 percent per year. Since 2006, real house prices have been flat.

So, can we explain the recent housing boom? For house prices to rise over time, something about housing must be hard to manufacture. For this reason, it makes sense to visualize a house as a physical structure on some land. Physical structures are like manufactured goods, and so the price of structures should show little upward trend, like the price of most manufactured goods. The red dotted line in the bottom panel of your exhibit shows that, in fact, the real price of structures has increased by only 35 percent since 1975. In contrast, land is not manufacturable, and this implies that changes to the demand for housing should be directly reflected in changes to the price of land. Shown by the solid line, the real price of residential land has increased by more than 250 percent since 1975. Viewed in this context, the housing boom experienced over the 1997 to 2006 period was a land boom; over this period, the real price of land increased by 10 percent per year.

A simple statistical model can explain *most*, but not all, of the recent boom to the price of land, which is the subject of the top panel of your next exhibit. For most of the sample period, real per-capita income, interest rates, and the inflation rate, have jointly explained the trend and cycles of the real price of land. The predicted price of land based on these three variables, the dotted line, closely hugs the actual land data, the solid line, until mid-2004, at which point the lines diverge. By last quarter, the actual price of land was 26 percent higher than its predicted price. A 26 percent overvaluation in the price of land currently translates to 12 percent overvaluation in house prices.

The bottom panel of exhibit 2 lists two possible explanations for why the actual price of land has outpaced the predicted price over the last three years. The first explanation is that there was a "bubble." There might be some merit to this story, but I'd rather focus on the second reason, which is that underwriting standards may have eased in 2004. A change of this sort is sufficient to cause a surge in the price of land. The reason is that there is a fixed supply of good locations. At any given price level, the number of potential buyers that can afford to live in any given location increases if credit becomes cheaper or more people have access to mortgages. In this case, the price of land must rise to clear the market.

Recently, however, underwriting standards may have become more strict. Thus, at current price levels, the number of potential buyers that can afford to live in any location has fallen. The price of land and housing must fall to clear the market for land. Assuming that underwriting standards have returned to pre-2004 levels, we might expect the price of land and housing to fall by 26 and 12 percent, respectively.

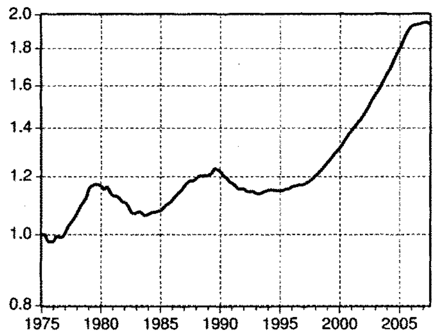
In the final exhibit, I make the case that the decline in house prices will be accompanied by a slowdown in residential investment and GDP. The top panel compares growth in real house prices, the solid line, with the share of GDP accounted for by residential investment, the dotted line. The correlation of these two series is 86 percent. Thus, if house prices fall, the odds are that residential investment will weaken. In the bottom panel, the solid line shows the percent deviation of real GDP from its trend and the dotted line shows the percent deviation of real residential investment from its trend. The historical correlation of these two series is 74 percent. Summing up, given that (a) residential investment is currently below trend, (b) we expect residential investment to fall further as house prices fall, and (c) cycles in residential investment and GDP are highly correlated, from a statistical point of view it seems highly likely that GDP growth will slow.

This concludes my prepared remarks.

Exhibit 1

Real House Prices

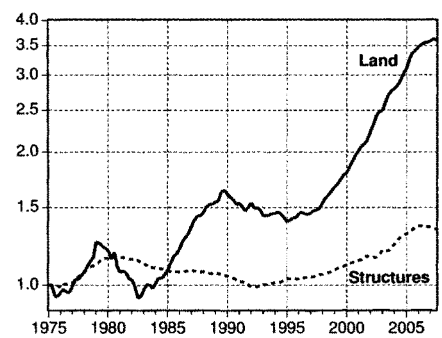
Log Scale. 1975:Q1 = 1.0. Data source: OFHEO



Period	Real Annual Growth Rate
1975:Q1 - 1996:Q4	0.6 %
1997:Q1 - 2006:Q2	5.7 %
2006:Q3 - 2007:Q3	0.1 %

Real Structures and Land Prices

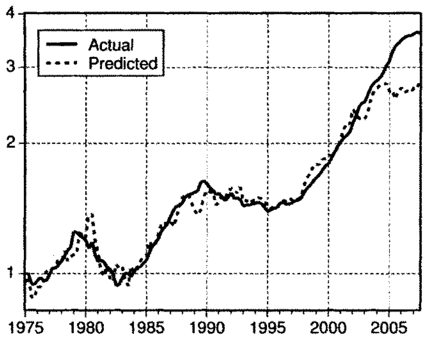
Log Scale. 1975:Q1 = 1.0. Data source: Davis and Heathcote (2007)



- Housing is land and structures
- House prices can increase if
  - ◇ Structures costs increase
  - ◇ Land prices increase
- Structures costs show little trend
- Land prices increasing over time

Exhibit 2

Actual and Predicted Real Land Prices
Log Scale. 1975:Q1 = 1.0. Data source: Author calculations

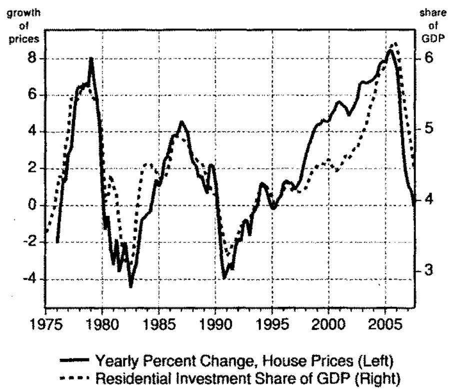


- Land prices a function of
  - ◇ Real disposable income
  - ◇ Interest rates
  - ◇ Inflation
- Model tracks until 2004:Q2
- Land now "overvalued" by 26 pct.
  - ◇ Housing is 44 percent land
  - ◇ Housing overvalued by 12 pct.

- Possible explanations for the 2004:Q2 - 2007:Q3 period:
  - Bubble
  - Change in credit conditions
- What happens if underwriting standards ease?
  - At current prices, more people can afford any given house
  - House prices must rise
- Suppose underwriting has returned to pre-2004 standards:
  - At current prices, fewer people can afford any given house
  - House prices must fall
- If house prices fall, expect a slowdown in residential investment and GDP

Exhibit 3

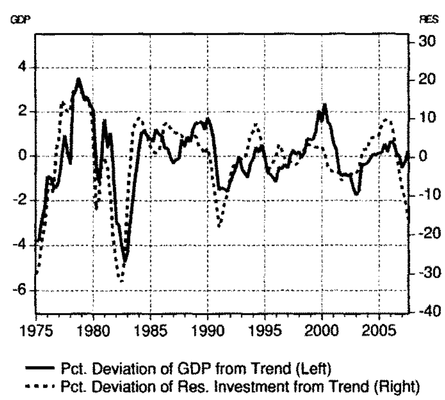
Yearly Real Percent Change in House Prices
and Residential Investment Share of GDP
Data sources: OFHEO and BEA



- Correlation of growth in house prices and residential investment share of GDP is 0.86

→ Expect further weakening of residential investment as house prices fall

Percent Deviations of GDP from Trend
and Residential Invest. from Trend
Data sources: BEA and author calculations



- Correlation of cycles in residential investment and GDP is 0.74

→ Expect weakening of GDP growth as house prices fall and residential investment weakens

SIFMA®
Securities Industry and
Financial Markets Association

Statement of Michael Decker
Senior Managing Director, Research and Public Policy

Before the
Committee on Finance
United States Senate

Hearing on
The Housing Decline: The Extent of the Problem and Potential Remedies
December 13, 2007

Good morning Chairman Baucus, Ranking Member Grassley and other members of the Committee. Thank you for the opportunity to testify today about the mortgage securities markets and tax proposals related to providing relief to homeowners in need of assistance. SIFMA[1] looks forward to working with you and the Committee on these proposals, just as we continue to work with Banking Committee Chairman Chris Dodd, who introduced comprehensive legislation this week, and Ranking Member Richard Shelby on subprime mortgage reform legislation and related housing matters.

The U.S. system of supplying credit for homebuyers has undergone a fundamental transformation over the last 20 years. Mortgage lending has gone from a business dominated by thrifts and other "portfolio" investors to one dominated by securitization. This transformation has reaped numerous benefits for homebuyers, investors and the economy as a whole. Until the subprime mortgage downturn this year, securitization was responsible for supplying more mortgage credit at a lower cost for disadvantaged families than would have ever been possible under the old "originate and hold" model.

Millions of eligible families have been able to purchase homes as a result of subprime mortgages and mortgage-backed securities. However, it has become clear that underwriting standards were, at times, too loose at the peak of the housing boom; subprime loans that should not have been made were made. This happened as a result of a combination of a period of historically low interest rates, overly optimistic assumptions, fraud or abuse on the part of both lenders and borrowers, speculation and an underpricing of credit risk brought about by a glut of investment capital from around the world seeking attractive rates of return.

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington, D.C., and London, and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

As it became apparent earlier this year that defaults and foreclosures in the subprime mortgage sector were spiking, the market for securities backed by subprime loans changed direction very quickly. Today, virtually no subprime mortgages are being originated. The securitization market for new subprime loans has shut down. The values of outstanding securities backed by subprime mortgages have dropped dramatically, and market liquidity—the ability to seamlessly trade securities in the secondary market—has dried up. Moreover, the deterioration of the subprime lending market has bled over into other credit sectors such as prime mortgage lending, commercial lending and corporate bonds, not just in the U.S. but in Europe and elsewhere as well. As one indication, the volume of asset-backed commercial paper outstanding has dropped from $1.2 trillion just four months ago to $800 billion today.[2]

Despite the severe downturn in the subprime market experienced this year, subprime lending has served the needs of homebuyers with weak credit; a large majority of subprime borrowers are able to pay their loans on time, and have been able to achieve the dream of homeownership. As indicated by the Mortgage Bankers Association's[3] most recent *Delinquency Survey* over three-quarters of outstanding subprime loans remain current.

The downturns in the subprime mortgage market and the credit markets more broadly have raised some questions regarding, for example, how thinly traded securities—in some cases, securities that were never designed to be traded at all—can be valued in difficult market conditions, or how the market can ensure that investors and others have adequate access to information on the structured securities they hold. SIFMA members and other market participants take these questions seriously, and we are working on solutions that will improve market practices without threatening the benefits of securitization for consumers and the economy as a whole.

Of note, Treasury Secretary Paulson announced last week a multi-pronged plan to assist struggling homeowners who will face a mortgage reset with a rising interest rate. The Treasury Department has proposed an expanded use of the qualified Mortgage Revenue Bond (MRB) program to help such homeowners refinance their subprime loans.

Tax-exempt qualified MRBs, issued by State and local government Housing Finance Authorities, are an important tool to finance low-cost mortgage loans for low- and moderate-income families. Under current law, qualified MRBs support new mortgages for first-time homebuyers for owner-occupied single-family homes. The proposal announced by Treasury would grant flexibility to State and local government authorities to issue tax-exempt MRBs to refinance existing subprime loans.

As Congress continues to explore efficient and flexible solutions for troubled homeowners, we support the idea of using tax-exempt bonds to accomplish this goal. The refinancing of existing loans to a lower interest rate remains a preferable outcome for troubled borrowers. We respectfully

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[2] Source: Board of Governors of the Federal Reserve System.

[3] Mortgage Bankers Association, *National Delinquency Survey, Q307*, December 6, 2007, page 5. Includes total delinquencies and foreclosures.

urge the Finance Committee's adoption of this proposal, and to consider exempting refinancing MRBs from the AMT to ensure market demand for these securities.

Background

Mortgage-backed securities (MBS) are securities backed by the cash flows from pools of mortgage loans. They are sold to investors much like stocks, government and corporate bonds, and other financial instruments, and are often structured to address a particular investor's risk preferences. The U.S. government has supported and encouraged the development of the MBS market by creating Fannie Mae, Freddie Mac and Ginnie Mae and by enacting other laws such as the Secondary Mortgage Market Enhancement Act of 1984 and the real estate mortgage investment conduit (REMIC) provisions of the Tax Reform Act of 1986 designed to facilitate the securitization of residential mortgages. The policy goal of these initiatives is to expand the availability of credit to home-buying families and reduce the cost of that credit.

Approximately $11 trillion of home mortgage debt was outstanding as of September 30.[4] As of the third quarter of this year, approximately $7.1 trillion of mortgage-related securities were outstanding compared to $4.4 trillion of U.S. Treasury securities and $5.7 trillion of corporate debt,[5] so about 65 percent of outstanding home mortgages are securitized. Securitization and the development of the secondary mortgage market have played a critical role both in expanding home ownership and in diversifying systemic risk within the banking system.

The capital provided to lenders by the secondary market through loan purchases and mortgage securitization has enabled larger segments of Americans to achieve the dream of home ownership. The secondary market has been critical in making affordable mortgages available to borrowers of all walks of life. From 1995 to 2005, the subprime mortgage loan market grew from $65 billion to $665 billion, dropping to $600 billion in 2006.[6] This growth was assisted by the funding provided through securitization for loans to subprime borrowers; issuance of MBS backed by subprime loans grew from $18 billion in 1995 to $508 billion in 2005, dropping to $483 billion in 2006.[7]

In addition to providing capital to facilitate the growth of home ownership, the secondary mortgage market and securitization have decreased systemic risk attributable to mortgage lending. The more efficient allocation of risk to both national and international investors through securitization reduces the concentration of risk that would otherwise be borne solely by local or national financial institutions due to fluctuations in local real estate markets. Such concentration of risk has caused problems in the past, most notably in the 1980s during the savings and loan crisis. Purchasers of MBS include institutional investors such as pension funds, investment funds, banks and insurance companies, both throughout the United States and increasingly throughout the world. Holdings of

[4]Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States*, December 6, 2007, page 93.
[5] Securities Industry and Financial Markets Association, *Research Quarterly*, November 2007, page 1.
[6] Inside Mortgage Finance Publications, *The 2006 Mortgage Market Statistical Annual, Volume I: The Primary Market*, 2007, pages 209-222.
[7] Inside Mortgage Finance Publications, page 3.

mortgage related securities are dispersed across a broad spectrum of industries and regions, with more than 15 percent held overseas.

Before securitization became prevalent, banks funded extensions of mortgage credit through their customers' deposits, and mortgage credit availability was dictated, in part, by the volume of bank deposits. Today, banks and other lenders have the option to sell their loans into the secondary market, facilitating the issuance of new mortgages and the dispersion of local lending risk.

The Subprime Downturn

By late 2006 and early 2007, the nationwide boom in residential real estate prices had come to an end. Average home sale prices nationwide have been on a steady decline in 2007, falling 4.2 percent in the 12 months preceding September of this year[8] after several years of annual increases in the neighborhood of 10 percent. This turnaround in real estate prices threatened the financing strategies of many subprime borrowers who had anticipated being able to sell their home at a profit or refinance into more affordable mortgage products based on a presumption of ever rapidly increasing home values. As home prices flattened out and then began to fall, delinquency rates on subprime loans steadily increased.

The effect in the capital markets was a drop in the value of securities backed by subprime loans. Figure 1 shows the value of the Markit ABX-AAA-HE 07-1 index, a market index of AAA-rated securities mostly backed by subprime mortgages. The index has declined in value more than 20 percent since June.

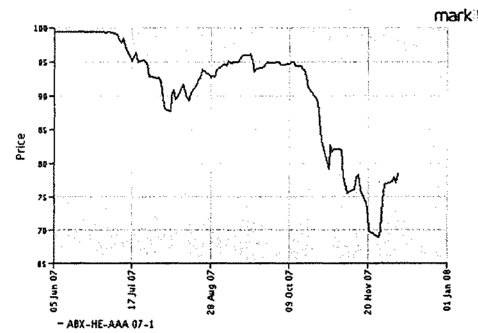

Figure 1.[9]

[8] National Association of Realtors, "Mortgage Availability Improving But Hampered September Existing-Home Sales," News Release, October 24, 2007.
[9] Source: Markit Group Limited.

The performance of lower rated securities has been even more severe. Figure 2 shows the value of the Markit ABX-BBB-HE 07-1 index of BBB-rated securities backed mostly by subprime loans. That index has lost 80 percent of its value since its creation earlier this year.

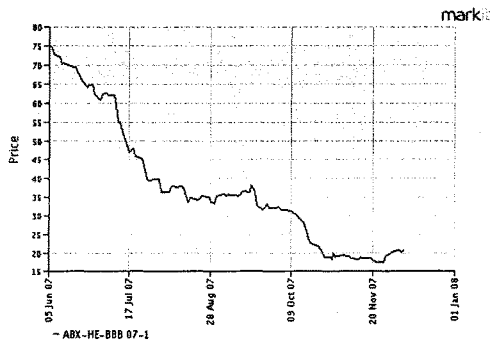

Figure 2.[10]

The spike in subprime defaults has also been reflected in downgrades of credit ratings on subprime-backed securities and other credit products. Deutsche Bank reported recently that there have been nearly 20,000 separate downgrades of subprime-backed securities and other credit products so far this year compared to around 2,500 for all of 2006.[11] Deutsche Bank concluded that "downgrades of collateralized debt obligations and sub-prime residential mortgage-backed securities accounted for nearly 75 percent of all volume-weighted downgrades this past year, and that it was even more alarming the degree to which very highly rated securities seem to have deteriorated overnight."[12]

Investors in subprime-backed securities have clearly suffered as a result of the market downturn. Estimates of total losses expected to be sustained by the global economy as a result of the correction in the credit markets sparked by the subprime downturn range from $150-400 billion.

Resolution

Currently there is an inventory of nearly 4.5 million existing homes for sale nationwide, a 10.8 month supply, compared to 3.9 million, or 7.4 months, a year ago and an average of 2.2 million, or 4.3 months, in 2004.[13] Reducing the inventory of new and existing homes for sale is key to an overall turnaround in housing. Home prices will need to continue to adjust to draw buyers to the market and reduce supply.

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[10] Source: Markit Group Limited.
[11] Duncan Kerr, "Investors 'Stunned' by 20,000 Ratings Cuts," *Financial News*, December 5, 2007.
[12] Duncan Kerr.
[13] National Association of Realtors.

At the same time, a deleveraging and recognition of losses, already begun at banks, securities firms, investment funds and others affected by the credit downturn, will help alleviate constraints in the supply of credit. Fortunately, despite perceptions to the contrary, overall credit in the U.S. is not contracting. The Federal Reserve reported recently that total borrowing in the U.S. in the third quarter expended at an annual rate of nearly $5 trillion in the third quarter, higher than any of the previous six quarters, despite a significant increase in the cost of credit across the board this year.[14] The Fed's monetary policy response to the downturn, cemented this week with another reduction in the funds and discount rates, will continue to provide a needed stimulus.

Conclusion

The evolution of mortgage securitization has been one of the most remarkable developments in the financial markets of the last 25 years. The mortgage securities market, now the largest sector of the U.S. fixed-income market, has brought benefits to homebuyers and has reduced risks for banks, thrifts and others engaged in home lending. Despite the downturn in the subprime mortgage market and the broader real estate sector, securitization will continue to provide a ready supply of capital to consumers and others.

[14] Board of Governors of the Federal Reserve System, page 9.

Cleveland State University
Cleveland-Marshall College of Law

Statement of Deborah A. Geier
Professor of Law, Cleveland-Marshall College of Law, Cleveland State University

Before the Senate Committee on Finance

At a Hearing on "The Housing Decline: The Extent of the Problem and Potential Remedies"

Mr. Chairman and members of the Committee:

I am pleased to have the opportunity to discuss with you the tax consequences that arise on debt foreclosure or workout pertaining to a principal residence. I shall discuss the rules that apply to debt-discharge income generally, how those rules apply in the specific context of debt pertaining to a principal residence, and why I believe that the relief provided in The Mortgage Forgiveness Debt Relief Act of 2007 (H.R. 3648), passed by the House of Representatives on October 4, 2007, is justifiable, except that I believe that—for conceptual reasons rather than revenue reasons—the relief should be temporary. Moreover, it would be conceptually defensible to dispense with the basis reduction required by H.R. 3648, though whether or not basis is reduced would likely have few real-world consequences. I explore each of these points below.

Sections 61(a)(12) and 108 of the Internal Revenue Code

Under our income tax, cash received is generally not includable in gross income so long as it is subject to an absolute and unconditional obligation to repay, which both parties acknowledge at the time of receipt.[1] This so-called borrowing exclusion does not mean that borrowed cash is not taxed at all. Rather, we usually tax borrowed cash upon *repayment* of the principal with nondeductible (*i.e.*, after-tax) dollars. That is to say, by denying deduction of the principal repayment, that repayment remains within the tax base for the year of repayment and is thus effectively taxed in that repayment year. If the repayment obligation disappears, however, the usual tax event (the act of repayment with

[1] *James v. Unites States*, 366 U.S. 213 (1961). In contrast, a cash receipt subject only to a conditional obligation to repay (rather than an absolute obligation to repay) is includable in the year of receipt. *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932). If the condition ripens and repayment actually occurs, the taxpayer would then generally be entitled to a deduction in the year of repayment.

after-tax dollars) will never occur. Without a tax rule to account for this nonpayment, the borrower will have received *permanently* tax-free cash in the year of original receipt (because it was not included in gross income in that year *only* because it was subject to an absolute obligation to repay that we now know will never occur).

We could, in that event, require the taxpayer to file an amended return for the year of receipt because now we know, with the benefit of hindsight, that it was not actually going to be repaid and that the premise of the exclusion was thus not satisfied. But that would be impossible if the year of receipt was beyond the three-year statute of limitations. More important, the exclusion was *proper* in the year of receipt because, in that year, everyone truly expected repayment in the future. Under the annual accounting principle, we typically account for changed circumstances in the year our expectations about what would happen do not materialize. Thus, § 61(a)(12) of the Internal Revenue Code provides that the discharge of debt results in gross income in the year of discharge. In this way, § 61(a)(12) ensures that the originally borrowed cash is not made permanently tax-free if the repayment obligation upon which the original exclusion was premised disappears.[2]

For example, assume that Borrower borrows $400,000 at market-rate interest in Year 1, incurring an absolute obligation to repay the $400,000 in Year 5. Under the borrowing exclusion, Borrower does not include this $400,000 in his gross income in Year 1, regardless of whether he uses that $400,000 for business, investment, or personal purposes. If all goes as expected, Borrower repays that $400,000 principal in Year 5 and is not permitted to deduct that repayment from his gross income (again, regardless of the use to which he put that $400,000 in the interim). Because Borrower was denied a deduction for that repayment, the $400,000 used to make that repayment remains within his tax base for Year 5 and is thus effectively taxed to Borrower in Year 5. If, however, the creditor discharges Borrower's obligation to repay that $400,000 in Year 5 for some reason, Borrower will not repay with after-tax dollars (the usual method of taxing Borrower on that $400,000). Thus, Borrower realizes $400,000 of § 61(a)(12) debt-discharge income in Year 5 to ensure that the original $400,000 receipt is effectively taxed.

Section 108(a)(1)(A) provides that § 61(a)(12) debt-discharge income may be excluded from gross income if the discharge is granted by a Bankruptcy Court or is

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[2] Instead of excluding borrowed principal on receipt and denying deduction on repayment (thus taxing borrowed money at the time of repayment), we could require inclusion of borrowed principal on receipt in every case (rather than only in those cases involving a conditional, rather than absolute, obligation to repay, as discussed in footnote 1) and then allow a deduction for principal repayments. In that case, we would not need § 61(a)(12) to ensure taxation of borrowed principal in the case of nonpayment. The taxpayer who fails to repay principal would simply lose the deduction that would otherwise attend the principal repayment. But, except with respect to receipts subject only to a conditional rather than absolute obligation to repay, such an approach has never been seriously considered in this or any other country employing an income tax. *See generally* Joseph M. Dodge, *Exploring the Income Tax Treatment of Borrowing and Liabilities, or Why the Accrual Method Should be Eliminated*, 26 VA. TAX REV. 245 (2006) (exploring, in part, whether a cash-flow approach to borrowing is conceptually superior).

pursuant to a plan approved by the court. This bankruptcy exclusion is not intended to be a complete forgiveness provision, however, but rather only a deferral provision. For every dollar of debt-discharge income excluded, the taxpayer must reduce valuable tax attributes listed in § 108(b), including net operating loss carryovers, capital loss carryovers, and basis in property owned by the taxpayer. The effect of these reductions should be that the taxpayer's gross income is higher in future years by an amount exactly equal to the amount excluded in Year 1. Because no interest is charged for the benefit of this deferral, however, the taxpayer is still better off because of the time value of money. Moreover, if the taxpayer possesses none of the tax attributes listed in § 108(b), the exclusion becomes, in effect, a complete forgiveness provision.

The bankruptcy exclusion is best understood as placing federal bankruptcy policy above a concern for the immediate collection of tax revenue. Absent this exclusion, the tax debt arising on the debt discharge in the bankruptcy proceeding itself would create a new creditor (the Internal Revenue Service), and under bankruptcy law this new creditor could jump ahead of other creditors in sharing in the bankruptcy estate. The exclusion prevents the creation of this new creditor so that other creditors take first. If, however, the taxpayer has any of the tax attributes listed in § 108(b), reduces them by the amount of the excluded debt-discharge income, and becomes profitable in the future, the government will nevertheless indirectly recover the tax due on the debt-discharge income realized in the earlier year.

If the debt is not discharged in a bankruptcy proceeding but the taxpayer can nevertheless show that he is "insolvent," he can exclude the debt-discharge income but only to the extent of his insolvency under § 108(a)(1)(B), (a)(3). Insolvency is measured immediately before the debt is discharged and is equal to the excess of the taxpayer's aggregate liabilities over the aggregate fair market value of his assets. For example, assume that Jacob owns assets worth $100,000 and has liabilities of $150,000 when a creditor cancels a $60,000 debt that Jacob owed him. If the cancellation occurs in a bankruptcy proceeding, Jacob's entire $60,000 of debt-discharge income is excluded from his gross income. If, however, Jacob is not in bankruptcy court when this happens, Jacob can exclude only $50,000 of the $60,000 debt-discharge income (*i.e.*, to the extent of his $50,000 insolvency measured before the debt discharge) and must immediately include the remaining $10,000. To the extent that Jacob has tax attributes listed in § 108(b), he must reduce them by the $50,000 that he excluded.

The insolvency exclusion is more difficult to rationalize. By definition, the taxpayer is not in bankruptcy court or the more generous bankruptcy exclusion would apply.[3] The

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[3] Moreover, no other type of gross income is excludable simply because the taxpayer is insolvent. Suppose, for example, that

> Hallie owed $20,000 to the local grocer by reason of buying subsistence food items on credit and had no assets. She had been taught that she is morally obligated to pay her debts. Consequently, she worked the graveyard shift at a deep coal mine, where the prevailing temperature was 115° F, until she earned $20,000 and paid her liabilities in full.

insolvency exception is likely no more than an historical artifact premised on Justice Holmes's early articulation of the reason why debt cancellation created debt-discharge income. In *United States v. Kirby Lumber*,[4] he reasoned that a debt discharge "frees up" assets previously subject to the cancelled liability, and it is this "freeing up" of assets that results in the realization of income. Subsequent courts early on concluded, based on this reasoning, that if assets weren't "freed up" upon the discharge of a debt because the taxpayer remained insolvent after the discharge, with all of his assets still effectively subject to liabilities, then no debt-discharge income was realized.

This "freeing up of assets" rationale for debt-discharge income no longer reflects current thinking.[5] The current rationale for debt-discharge income, as described above, is premised on the borrowing exclusion itself. Regardless of whether the taxpayer is insolvent, the taxpayer's original receipt of excluded cash would become permanently tax-free upon debt cancellation absent the realization of debt-discharge income. Congress has indicated its acceptance of this more modern thinking when it created current § 108 in 1980. The common-law insolvency exclusion that the statutory exclusion replaced was a complete forgiveness provision; the insolvent debtor was never deemed to realize debt-discharge income in the first place. As described above, however, the statutory insolvency exclusion under current § 108 is not usually a complete forgiveness provision but rather only a deferral provision. Debt-discharge income *is* deemed to be realized by the insolvent debtor, though taxation of this income is deferred through the mechanism of reducing the valuable tax attributes listed in § 108(b) by the excluded amount.

Debt Foreclosures and Workouts Pertaining to a Personal Residence

Suppose that Tom purchased a primary residence for $5,000 in cash plus $195,000 in debt in 2005, resulting in a $200,000 cost basis.[6] When the unpaid principal balance remains $195,000 on his interest-only loan, Tom discovers that the fair market value of his home has been reduced to $170,000 in 2007. He defaults on the debt, and the lender forecloses, taking title to the property.

In most instances, Tom's transaction is bifurcated into its two component parts for tax purposes. First, Tom is deemed to sell the property for its $170,000 current value, and then he is deemed to use the $170,000 proceeds to settle the $195,000 outstanding debt.[7]

Joseph M. Dodge, J. Clifton Fleming, Jr., & Deborah A. Geier, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, & POLICY 310 (3d ed. 2004). Even though she was insolvent throughout this period, her compensation income is not excludable from gross income. If, however, the grocer cancelled the debt, Hallie could exclude that particular kind of gross income because of her insolvency.

[4] 284 U.S. (1931).

[5] *See generally* Deborah A. Geier, *Tufts* and the Evolution of Debt-Discharge Theory, 1 FLA. TAX REV. 115 (1992).

[6] Under *Crane v. Commissioner*, 331 U.S. 1 (1947), debt used to acquire property is included in the cost basis of that property.

The deemed sale will result in a $30,000 loss under § 1001 ($170,000 amount realized *less* $200,000 basis). This loss would be nondeductible under § 165(c) because it arose from the sale of personal-use property. The deemed debt settlement will result in $25,000 of debt-discharge income if the lender discharges the shortfall ($195,000 debt *less* $170,000 repayment), which is excludable under current § 108 only if Tom is insolvent (or the discharge occurs in bankruptcy court).

Alternatively, assume the same facts except that the lender does not foreclose but rather reduces the outstanding $195,000 debt in a workout to $170,000 to reflect its current value. Because there is no property transfer, there is no § 1001 calculation (and no resulting nondeductible personal loss). But, as before, Tom nevertheless realizes $25,000 of debt-discharge income that would be excludable only if Tom is insolvent or in bankruptcy court.[8]

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[7] *See* Treas. Reg. § 1.1001-2(a)(2) and -2(c) Ex. 8; Rev. Rul. 90-16, 1990-1 C.B. 12.

[8] A different analysis would arise if the debt were considered "nonrecourse" rather than "recourse." A "nonrecourse" debt is one for which the taxpayer is not personally liable. The lender's only recourse on nonpayment is foreclosure on the property security. A "recourse" debt may also be secured by property, but the lender's recourse on nonpayment goes beyond taking possession of the property security and, depending on state law, can result in liens being placed on other property owned by the taxpayer or even wage garnishment.

With respect to a transfer of property subject to a nonrecourse debt, the "collapsed" approach adopted by the Supreme Court in *Commissioner v. Tufts*, 461 U.S. 300 (1983), and reflected in Treas. Reg. § 1.1001-2(a)(1) would apply instead of the "bifurcated" approach described in the text. Under the collapsed approach, Tom is not considered to first sell his property for its value (requiring computation of his sale gain or loss under § 1001) and then to settle the debt with the amount deemed realized on the sale (which would create debt-discharge income to the extent the debt exceeds the deemed sales proceeds). Rather, only a § 1001 calculation is done, and the debt relief is thrown into the taxpayer's "amount realized" under § 1001(b) from which basis is subtracted to create either a gain or loss. No debt-discharge income is deemed realized. Thus, in the text's hypothetical, Tom would be deemed to realize only a $5,000 nondeductible personal loss ($195,000 amount realized equal to the debt relief *less* $200,000 basis) and no debt-discharge income.

How do we know whether mortgage debt with respect to a personal residence is "recourse" or "nonrecourse"? Under current law, we do not have any guidance on how to make this determination. If we are limited to looking at the four corners of the loan documents, virtually all home loans are recourse. If, however, we are permitted to look beyond the loan documents to the effect of state statutes, apparently California law often prevents lenders from looking beyond the personal residence for repayment in most, if not all, cases. Does the effect of the state statute turn the loan, nominally recourse under the loan documents, into a nonrecourse loan? If we are permitted to look beyond the loan documents to state statutes, would it be permissible to look even further to the reality that most lenders making home loans—wherever located—look *only* to the value of the home for repayment, notwithstanding the nominally recourse label used in the documents? As I understand it, most lenders do not often pursue liens on other property owned by the home owner, wage garnishment, *etc.* If home loans were characterized under any of these theories as "nonrecourse," we need no change in statutory law in the transfer situation. *Tufts* comes to Tom's rescue already; he would realize no debt-discharge income.

However, *Tufts* would provide no relief in the workout situation where the debtor retains ownership of the home. A cancellation of nonrecourse debt *without* a transfer of the property security creates debt-discharge income equal to the amount cancelled. *See* Rev. Rul. 91-31, 1991-1 C.B. 19. This is one reason

Many taxpayers like Tom are not, in fact, legally insolvent because of retirement savings that cannot be accessed without stiff tax penalties. Though they may be functionally insolvent (with credit card and mortgage debt exceeding the reduced value of the home and other assets outside retirement accounts), they are not legally insolvent and thus gain no protection from the insolvency exclusion. These are the taxpayers that would be protected by H.R. 3648.

H.R. 3648

Under H.R. 3648, the solvent taxpayer would be permitted to exclude debt-discharge income realized on or after January 1, 2007, with respect to the taxpayer's primary residence to the extent of $2 million so long as the discharged debt satisfied the definition of "acquisition indebtedness" within the meaning of § 163(h)(3), pertaining to the deduction of qualified residence interest (other than the $1 million ceiling usually applicable to "acquisition indebtedness"). "Acquisition indebtedness" is debt that is secured by a personal residence and that was incurred to acquire, construct, or substantially improve the home (as well as debt that was used to refinance such debt). Thus, not only "first mortgages" can qualify. Second mortgages and home equity debt (in the non-tax sense of the term) can quality as "acquisition indebtedness" to the extent that the proceeds were used for one of the qualifying purposes. Home equity debt that is not used to acquire, construct, or substantially improve the home may produce deductible "qualified residence interest" under § 163(h)(3), but the discharge of such debt would result in debt-discharge income that could not be excluded under H.R. 3648 but rather could be excluded only to the extent that the taxpayer was in bankruptcy court or was insolvent.

H.R. 3648 provides that the amount excluded would reduce the basis of the personal residence only (and not any of the other tax attributes listed in § 108(b)), though it is not clear whether this basis reduction would occur in the year of the discharge or (under the

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why simply extending the *Tufts* approach to home mortgage debt foreclosures (even if the debt is recourse) would be incomplete relief.

Moreover, even in the transfer situation, *Tufts* is unwise law, in my view, because failing to bifurcate the transaction into its component parts can undermine Congress's rules for each separate leg. Moreover, having different rules in the transfer context for debt in excess of the value of the property, depending on whether the debt is styled "recourse" or "nonrecourse," and having different rules for nonrecourse debt itself, depending on whether the property security is transferred (no debt-discharge income but only a § 1001 calculation) or retained (debt-discharge income) works chiefly to encourage economically inefficient tax-motivated transactions whose sole aim is to opt into or out of these disparate rules, a phenomenon I describe more fully elsewhere. *See* Deborah A. Geier, *Another Take on the Home Mortgage Debt Relief Situation*, TAX NOTES (Oct. 22, 2007). These discontinuities would have never materialized if the government had adopted the bifurcated approach in the *Tufts* context, as well. Whether the debt is recourse or nonrecourse would not matter to the tax outcome. Whether the property were transferred, on the one hand, or retained with a negotiated partial debt cancellation on the other, would not matter to the tax outcome. Inefficient tax-motivated transactions would not occur. I think that would be a change for the better. For these reasons, I do not advocate an approach to the current home mortgage problem that would extend *Tufts* to home mortgage foreclosures. A narrowly tailored relief provision in § 108 is more appropriate, in my view.

usual rule in § 108) would occur at the beginning of the following taxable year. If the usual rule applied (the basis reduction occurs in the year following discharge), whether the basis reduction would have any effect would turn on whether the debt was discharged on a foreclosure transfer or in a workout, with the residence retained by the taxpayer. In the former, the basis reduction could have no effect, as the taxpayer no longer owns the residence. In the latter, where the taxpayer continues to own the residence, the basis reduction could produce a larger realized gain (or a reduced realized loss) on later sale. If sold at a gain, however, the gain might nevertheless be excluded under § 121, which generally allows exclusion of up to $250,000 of realized gain ($500,000 for married couples filing jointly) on home sale gain so long as the taxpayers owned and resided in the home for at least two of the previous five years.

If, contrary to the current § 108 approach, the basis reduction is deemed to occur in the same year as the property transfer, the basis reduction would have the same result in the workout situation. In the transfer situation, the basis reduction would typically reduce the amount of nondeductible loss realized by the taxpayer. In our hypothetical, Tom—who would be permitted to exclude the $25,000 of debt-discharge income under H.R. 3648 even if he is solvent—would reduce his $200,000 basis to $175,000. Because, in the first step of his bifurcated analysis, he is deemed to sell the property for its $170,000 value, his nondeductible loss would be reduced from $30,000 to only $5,000. Because the loss is nondeductible, however, the basis reduction has no real effect.

Analysis and Recommendations

Because H.R. 3648 effectively applies only to solvent taxpayers, the central question is whether the solvent taxpayer is deserving of any exclusion here. The key to understanding this analysis, in turn, is the treatment of the loss on the deemed sale of the residence in the first step of the bifurcated treatment. Recall that, in our hypothetical, Tom's transfer in foreclosure results in a $30,000 nondeductible personal loss (the difference between the home's $170,000 value at the time of the transfer in foreclosure and Tom's $200,000 original purchase price) and $25,000 of debt-discharge income (the difference between the $195,000 debt owed and the $170,000 value of the house transferred to settle the debt). The problem arises here chiefly because personal residences are categorized for tax purposes entirely as personal-use assets providing personal consumption. Wealth used in consumption should not reduce the tax base under income tax principles. Thus, personal residences are not depreciable (as are business and investment real estate), and losses on sale are not deductible.[9] In contrast, if Tom had

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[9] For non-tax purposes, personal residences are viewed by most people as mixed-use property. That is to say, a home provides shelter (personal consumption), but it also provides the chance for value appreciation (investment). Indeed, most middle class taxpayers see their home as their primary investment vehicle. Most indivisible mixed-use outlays that contain both personal and income-producing components are nevertheless categorized in an all-or-nothing manner for tax purposes as either wholly personal or wholly business/investment. The one exception is a business meal or business entertainment. Section 274(n)(1) provides that 50% should be allocated to personal consumption (not deductible) while 50% can be allocated to income production (deductible).

bought stock instead of a personal residence with the debt, his $30,000 loss would be deductible.

In a more normal market for personal residences, this categorization of personal residences as personal-use assets that cannot produce deductible losses is generally a good rule. If a home loses value in such a market (when most homes at least maintain nominal value, if not appreciate), the reason is usually because the owner failed to maintain the home or made idiosyncratic changes that she liked but which the market abhorred. That is to say, the value loss is usually due to personal consumption of the taxpayer, just as use of a personal-use car, which reduces its value, reflects personal consumption of the driver. In that case, the value loss reflects personal consumption and thus should remain in the taxpayer's tax base. Application of the usual rule results in this treatment: the loss is nondeductible and the debt, which effectively paid for this personal consumption, results in includable gross income if the debt is discharged.

But in the current unusual market conditions, the value loss of the personal residence does *not* likely reflect personal consumption of the taxpayer. The loss in value wasn't consumed by Tom but rather was an artifact of this unusual market. Tom still cannot deduct the loss, however.

In other words, the problem arises here chiefly because the Internal Revenue Code, in effect, *assumes* that any loss in value of a personal residence is due to personal consumption rather than market forces unrelated to the taxpayer's consumption. That is usually true and thus a good rule. Historically, most well-maintained homes at least retain nominal value over time. But today the unusual market conditions mean that in many cases the loss in value is due to market conditions (as occurs with investment property like stocks and bonds) and *not* to any personal consumption of the taxpayer. Thus, the only way to properly measure this taxpayer's wealth is to conclude that the debt-discharge income should not be taxed.[10]

In an ideal world, we would identify those value losses resulting from consumption by the taxpayer and those resulting from market forces unrelated to consumption by the taxpayer. Those debt discharges resulting from the former would result in includable income by the solvent taxpayer, whereas those debt discharges resulting from the latter would not. Because I do not think it would administratively feasible to make such identifications, however, I believe that the H.R. 3648 should be made temporary. The current market conditions are unusual. Because most home value losses today are more likely due to these market conditions rather than due to personal consumption, it might be

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[10] Temporarily making deductible a realized loss on a foreclosure transfer of a personal residence (because not representing personal consumption in this unusual market) combined with inclusion of the debt-discharge income by solvent taxpayers would not be an adequate remedy, as it would do nothing for the owner who remains in his home after a debt workout with his lender. The loss in home value, which convinces the lender to reduce the debt, is not "realized" absent a transfer of the home, and thus the loss could not be deducted in any event. Amendment to § 108 would, in contrast, provide appropriate relief to both taxpayers who transfer in foreclosure and taxpayers who have their debt reduced in a workout but who retain their home.

administrable "rough justice" to allow *all* such debt-discharge income to be excluded without a specific showing that the home's loss in value was due solely to market conditions rather than personal consumption. But that will not be true forever; the home market will eventually revert to the historical norm where most well-maintained homes at least hold their nominal value (if not actually appreciate over time). When that happens, most value loss, if it occurs, will be due to personal consumption and thus any resulting realized debt-discharge income should be includable by the solvent taxpayer.

How long such a temporary measure should last depends on how long it is anticipated that the market will continue to experience across-the-board value reductions that do not represent personal consumption by owners. This is a non-tax empirical prediction outside my expertise.

I also argue that the pending bill is correct to allow exclusion only for discharged acquisition indebtedness (including second mortgages and home equity debt, in the non-tax sense of the word, to the extent that it was used to substantially improve the home). It would not allow exclusion of discharged home equity debt used to fund personal consumption. I believe that treatment is correct, as such debt is tantamount to credit card debt that just happens to be secured by the home. If such debt is cancelled, the justification for exclusion described above (that the debt relief does not likely reflect personal consumption by the taxpayer) disappears.

I also see no reason (from a conceptual point of view) to limit the exclusion to $2 million of debt relief. If the loss in home value truly does not reflect personal consumption by the taxpayer, it should not be taxed (at least as a conceptual matter), as only "income" is intended to be captured under the income tax. If after careful consideration we choose to tax apples instead of oranges, a person with oranges should not be taxed, even if he could afford to pay the tax. The underlying conceptual analysis described here is not affected by the degree of debt relief.

Next, because the underlying conceptual analysis is premised on the assumption that the home value reduction in today's market does not represent personal consumption by the taxpayer, I see no reason to require a basis reduction in the personal residence, which is usually intended under § 108 to result only in deferral rather than forgiveness. For the reasons described earlier, Congress has made the decision to defer the tax due on debt-discharge income realized by the bankrupt or insolvent taxpayer but not to forgive it. That approach, however, assumes that the debt discharge, as a conceptual matter, properly produces "income," even though the taxation of that income should be deferred for policy reasons. In contrast, the debt discharges in the current home mortgage market are due to unusual reductions in home values that do not truly represent personal consumption by the taxpayer and thus should not be taxed in the year of discharge or any other year.

I believe that the basis-reduction rule in H.R. 3648 was inserted, without reflection, simply because we see such deferral (rather than forgiveness) in connection with the bankruptcy and insolvency exclusions in general. Because H.R. 3648 is premised on far different underlying conceptual grounds, the usual approach need not necessarily apply. If the Committee decides to keep it simply for the sake of formal consistency, however, in most instances the basis reduction would not result in any real-world consequences. It would either increase the amount of nondeductible loss or produce gain that is likely excludable under § 121.

Finally, whether the proposed January 1, 2007, effective date of H.R. 3648 is adequate to capture the debt discharges arising because of falling home prices is an empirical question beyond my expertise. If there is substantial evidence that these foreclosure transfers (or debt workouts) due solely to market value reductions began before 2007, then the provision should be made retroactive to the date when they began. If the debt discharge does not properly reflect "income" as a conceptual matter (because not reflecting personal consumption of the home by the taxpayer), then it should not matter when it arises; it should not be taxed.

THE HOUSING DECLINE: THE EXTENT OF THE PROBLEM AND POTENTIAL REMEDIES
TESTIMONY BEFORE THE U.S. SENATE
COMMITTEE ON FINANCE
DECEMBER 13, 2007
BY
JACK KEMP

Chairman Baucus, Ranking Member Grassley and Members of the Committee. I appreciate this opportunity to appear before you today. There is nothing more important that the Congress can do for the economy than to find measured and effective solutions to what has become a full-blown disruption in this nation's mortgage markets.

Mr. Chairman, I scarcely need to tell you about the role homeownership plays in this society. It embodies the American Dream and represents an invaluable economic asset for millions of families. A strong housing market has been a principal engine for our nation's economic growth, contributing to the development of stable and thriving communities, broadening the tax base, and rising employment opportunities.

Today's housing recession is serious, but far from devastating for our rather robust national economy. The subprime mortgage meltdown exists because there was an abundance of liquidity and soaring property values in many areas of the country, which allowed for exuberant lenders to provide ill-advised subprime loans, particularly Adjustable Rate Mortgages, which represent about 60% of foreclosures.

The impact of the subprime mortgage contraction is clear in certain areas; lending standards are tightening, subprime lenders are going out of business and the large investment banks are suffering significant losses after huge revenue increases resulting from the housing market. Most importantly, hard working Americans' homes are in jeopardy because the value of their home is less than their actual mortgage.

We face a difficult question: how can the government help homeowners without putting taxpayer dollars at risk, sending wrong signals to the housing market or over-regulating the industry?

Certainly we can't solve every homeowner's problems, but our immediate goal should be to meet proactively the legitimate needs of perhaps millions of American families who are at risk of losing their homes.

Quoting economist David Malpass of Bear Stearns, "Estimates of the recession risk have gotten overdone, in our view. In contrast with previous pre-recession periods, we note a proactive Fed, low real interest rates currently and in recent years, strong profits (they typically decline for multiple quarters prior to a recession), low jobless claims, strong equity performance, reservoirs of global liquidity, and strong foreign growth. We're maintaining our assessment of the recession risk at 20 percent)." I would add, it's my belief that the Federal Reserve should have been more aggressive in lowering interest rates by at least 50 basis points or more, rather than 25 basis points.

Another well-respected economist, Arthur Laffer recently said that "Over the last year and a half we have had a housing industry in the U.S. that has fallen off a cliff. Housing was one of the biggest contributors to GDP growth back in the 2005/2006 era and now is a huge, huge detractor from GDP. If you looked at it in isolation, you would say that that should lead to a downturn, or even a recession. This is what almost all the forecasters have been saying when they add up all the components of GDP, but that is not the right way to do it. When you look at the different sectors of the economy, you don't just add up what happens in each sector, you look at the total interaction of all of the components of GDP. Housing construction has fallen, and that by itself should have led to a very sharp decline in not only GDP growth but also absolute GDP. But what has actually happened is that the trade deficit has declined substantially over this period, going from 6.2 percent of GDP to 4.8 percent of GDP. Trade has, in fact, added to GDP growth a little bit more than housing has reduced it. Therefore, total GDP growth has risen, not fallen, in spite of the fact that there has been a falloff in the housing industry. The loss of GDP in the housing sector will be made up for by gains in GDP in other sectors. The traded goods sector has done very well, more than offsetting the declines in GDP attributable to housing and finance."

There is no need for the Federal government to be intrusive or overreact by changing basic economic policies. It just needs to be responsive to the real causes and effects of the subprime crisis. In my opinion, this means that our government must maintain a legal and regulatory structure that protects citizens and promotes fair business practices.

I am suggesting a three-pronged approach to this crisis that will be effective in dealing with the immediate effects of the current crisis and also help prevent a future recurrence. This approach requires the active involvement of several Congressional committees as well as Federal financial institution regulators.

First, Congress should provide mortgage tax relief so that people don't get taxed on loan forgiveness. Under current law, if the value of a house declines and the bank forgives a portion of the mortgage, the tax code treats the amount forgiven as taxable income. Congress should reform the tax code to fix this problem on a temporary basis. H.R. 3648 that passed the House on a bipartisan basis is a good start and S. 1394 should be acted upon by the Senate without delay.

The Administration has also proposed allowing cities and States to issue tax-exempt mortgage bonds to refinance existing loans. Under current law, cities and States can issue tax-exempt bonds to finance new mortgages for first-time homebuyers, and this measure would give State housing finance authorities more flexibility to help troubled borrowers. Again, as long as this is also a temporary solution, I believe it merits support.

We should resist long-term tinkering with the tax code to address short-term problems. Our economy is fundamentally strong, and the U.S. government does not need to react with regulation or increase the tax burden on our nation. To the contrary, the Federal Reserve needs to continue to value a strong U.S. dollar and provide liquidity to our markets. Maintaining current tax policies will also allow our GDP to continue its solid growth, which will ensure that the pain of this housing decline doesn't spread throughout our economy, which will be the greatest tool in allowing our housing industries to regain their footing.

Second is a limited change to our bankruptcy laws to provide relief for distressed homeowners. Yesterday, important legislation passed the House Judiciary Committee to let bankruptcy judges give the same relief on home mortgages already available on commercial real estate loans, vacation home loans, car loans and other secured debt. This legislation doesn't cost taxpayers anything, and allows people who are able to make payments on the current market value of their homes to keep those homes. In the absence of this legislation, these homes will certainly be lost to foreclosure. It is estimated that over 600,000 homeowners will be able to use bankruptcy protection to modify mortgage loans and stay in their homes.

I hope the House will adopt H.R. 3609 - "The Emergency Homeownership and Mortgage Equity Protection Act of 2007" and the Senate will rapidly follow suit.

Third, there needs to be better scrutiny of lending practices and the rating agencies themselves. There is a consensus that the lack of effective oversight by the regulators of the primary and secondary mortgage markets contributed significantly to the problem we are now facing. Innovations in the mortgage industry can be good and useful. In fact, innovations by FHA, the secondary market and private sector lenders have been responsible for much of the unprecedented increase in the homeownership rate since World War II. At the same time, however, regulators can't be asleep at the switch and permit clearly unsound mortgage lending practices that place ordinary homebuyers at risk.

I applaud the White House and Treasury Secretary Paulson's efforts to encourage mortgage servicers to modify existing loans for a limited number of borrowers that cannot afford interest rate resets. However, depending solely upon the goodwill of an industry that bears no small measure of responsibility in this crisis is not the full answer. Moody's reported recently that servicers modified only 1 percent of mortgages that reset to higher rates this year.

Secretary Paulson and banking executives have also created a voluntary approach to freezing introductory rates; however the reality is that their proposal will help fewer than 5 percent of the people the proposal is trying to assist.

Voluntary actions after the damage has occurred are admirable, but hardly a substitute for ongoing, sound regulatory policies that make the mortgage lending industry more transparent, reliable and fair and protect homeowners from abusive or predatory lending practices.

Let me make a couple of comments about the Federal Housing Administration—FHA. For almost 60 years, FHA was the principal source of mortgage insurance that allowed millions of low- and moderate-income families to achieve the dream of homeownership. In recent years, an FHA in need of modernization has lost much of its market share to subprime mortgage providers whose lending guidelines have helped precipitate the current crisis. FHA must again become the principal responsible lending partner for those who need access to capital in order to own their home.

FHASecure, which the Administration has implemented, would expand the FHA's ability to offer refinancing by giving it the flexibility to work with homeowners who have good credit histories but cannot afford their current payments. FHA modernization would allow the FHA to insure bigger mortgages in high-cost states and expand FHA's authority to price insurance fairly with risk-based premiums. The House has passed FHA modernization legislation in each of the last two years. The Senate Banking Committee approved a modernization bill months ago but has been unable to move it to the floor.

In closing, Mr. Chairman let me restate that the most pressing need is to help the 2.2 million families who are in danger of losing their homes. Of course, we need sound policies that prevent the kinds of abuses and disruptions we are now experiencing. But to help current homeowners we need measured and appropriate responses that have an immediate effect, to protect our citizens and encourage sound business practices.

Why do we need to keep people in their homes? As HUD Secretary, I saw firsthand that homeownership makes our neighborhoods safer, encourages investment and raises families' overall standard of living. People care more deeply about their neighborhoods if they have an ownership stake. Minorities, especially, need to become homeowners in greater percentages if America is to truly democratize our free economic system. The subprime mortgage meltdown – and the practices of a few bad actors – should not obscure the great continuing benefits of homeownership.

Homeownership is not about left or right, conservative or liberal, Democrats or Republicans. For the past quarter-century, Republicans and Democrats have united around a conviction that owning a home is good not just for individuals and families, but also communities and for our country as a whole. Over the last 15 years, homeownership, especially among people of color, has risen to historic levels. In just the past five years alone, 2.8 million families achieved homeownership for the first time, and the ownership rate for minorities, while still far too low, surpassed 50 percent. I hope the government's response will focus on preserving the enormous gains we have made and protecting those for whom the Dream has yet to become reality.

Thank you, Mr. Chairman.

Kudlow's Money Politic$

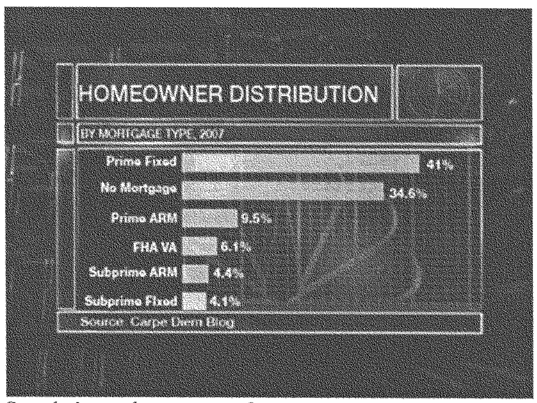
PRO-GROWTH, STRONG DEFENSE, VIRTUOUS VALUES, BUSINESS, AND STOCKS

Kudlow 101: Foreclosures & The Fed

Tuesday, December 11, 2007

The Fed is linked to foreclosures, and they can do something about it.

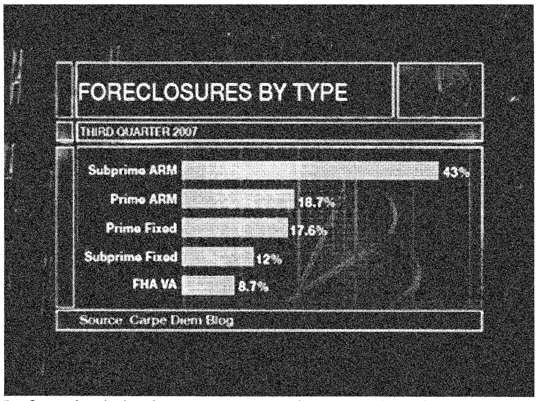
Take a look at the following homeowner distribution chart. It shows where all the mortgages are. It may surprise you to see who's holding what kind of paper. (Hat tip to University of Michigan Professor Mark Perry and his fabulous blogsite, **Carpe Diem**. He put this together using Mortgage Bankers Association data.)



So, who's got the mortgages?

Well, Prime Fixed comprises 41 percent. That's the biggest share. Next up is Americans with no mortgages at all; they're at 35 percent. And so on down the list. But I'd like to draw particular attention toward the bottom of the list, to the Subprime ARM group. They've got a 4.4 percent share. That's obviously a very small percentage.

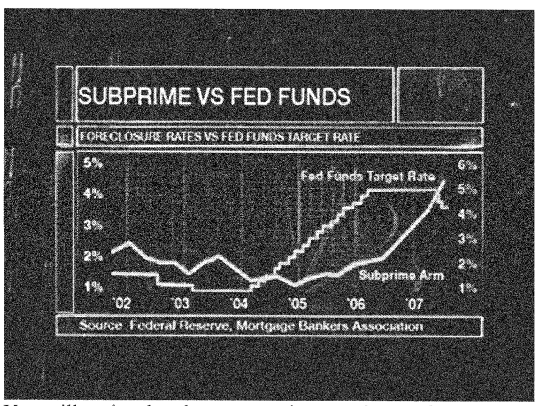
This next chart (also courtesy of Carpe Diem) shows you where the foreclosure problem resides. The following point is key: *the smallest is the largest*. In other words, the Subprime ARM is where the bulk of the foreclosures are.



In fact, the Subprime ARM group is responsible for 43 percent of foreclosures. But that group is a very small percentage of total mortgage holders. Moreover, the next group on the foreclosure list is the Prime ARM. They've got an 18.7 percent share. Add them together and over 60 percent of foreclosures are ARM related. In other words, it's the skyrocketing of adjustable rates over the past couple years that's the problem.

That's the key point. It's the adjustable rates—affected by the Fed—that's caused the problem.

Okay, last chart. This shows the relationship between the fed funds rate and the subprime foreclosures. This is absolutely incredible.



You will notice that they are moving together. In fact, they start moving together in '04. So there is a clear link between tight money from the Fed and the foreclosure rate.

The point of all this is to suggest that the Federal Reserve bears some of the blame for the huge increase in these adjustable rates. Frankly, very few people (and almost no economists) predicted rates would rise from 1 percent to 5.25 percent. So if the Fed truly wants to help people, they should get that funds rate down, so the pressure will come off adjustables.

OPENING STATEMENT
SENATOR KEN SALAZAR
FINANCE COMMITTEE HEARING
"THE HOUSING DECLINE: THE EXTENT OF THE PROBLEM AND POTENTIAL REMEDIES"
December 13, 2007

Our nation is in the middle of a crisis in the residential housing market. While the impact of this crisis is severe enough on the families who overextended themselves and on their neighbors who bought homes expecting their values to continue to increase, the most disturbing thing about the crisis is that it threatens to create a serious drag on the economy as a whole.

When our nation encounters a crisis of this scope, and when the government begins to contemplate ways in which it can be a part of the solution, we often hear cries about a potential "bailout." In my view, this is not about bailing out people who made bad decisions. This is about two very specific things: (1) providing relief to the segment of the population that fell victim to the perfect storm of extremely cheap credit, overconfidence in the housing market, and unscrupulous or reckless practices of lenders and brokers, and (2) putting the breaks on a growing wave of foreclosures that is threatening to drag our whole economy into a recession.

In its early stages, the housing crisis hit my state of Colorado especially hard. Last spring, one in 339 homes in Colorado was in some stage of foreclosure – the highest rate in the nation. While Colorado's national ranking has dropped over the past year and a half – due to much higher foreclosure rates in certain other states – foreclosures continue to grow in my state. According to the Colorado Division of Housing, foreclosures have increased by well over 100% since 2003.

There is no silver bullet to this problem. However, there are steps we can take now to provide some measure of relief to those who have already been affected, and to protect others from being in the same position in the future. Along those lines, I am pleased that Colorado acted quickly to create a mechanism to help citizens who were affected – or who might potentially be affected – by the foreclosure crisis.

Last fall, a consortium of government, private-sector and non-profit organizations launched the Colorado Foreclosure Hotline, which connects borrowers with non-profit housing counselors who can provide information on a borrower's options when facing foreclosure. Counselors can also act as facilitators for communication between lenders and borrowers.

The hotline has proven to be an enormous success, fielding over 10,000 calls in the first six months following its launch. The hotline receives about 75 calls a day. According to a recent report by the Colorado Division of Housing, at least 4 out of 5 callers to the Colorado Foreclosure Hotline who meet with housing counselors avoid foreclosure.

While counseling services are part of the answer, there are things that those of us here in Congress – and on this Committee – can do to help provide direct financial relief to families facing foreclosure. There are two tax-related proposals in particular that both Congress and the Administration have put forward as possible solutions: tax relief for Americans who have had their debts forgiven, and an expansion of the use of private-activity bonds specifically dedicated for home loans.

I am interested in hearing more from our witnesses about these ideas, and about how to move forward generally on this issue in a way that helps American families who find themselves in a difficult position and mitigates the impact of the foreclosure crisis on the economy as a whole, without encouraging some of the shortsighted decisions that contributed to this crisis in the first place.

Thank you.

COMMUNICATION

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Statement for the Record

United States Senate Committee on Finance

The Housing Decline: The Extent of the Problem and Potential Remedies

December 13, 2007

Tax Policy Recommendations for the Crisis in Housing

Introduction

On behalf of our 235,000 members, the National Association of Home Builders (NAHB) appreciates the opportunity to submit this statement for the record on today's hearing - *The Housing Decline: The Extent of the Problem and Potential Remedies.* Home builders are on the front lines of the nation's housing and mortgage crisis. NAHB has analyzed how this crisis arose, how long it could last, what the short- and long-term impacts may be and, most importantly, how to minimize those impacts by addressing the most critical issues. This statement is a reflection of that analysis and ongoing discussions within the mortgage industry organized and led by NAHB. We stand ready to work with the Committee and the Congress to craft a package of solutions that best meet the needs of individual homeowners, local communities and the national economy.

Housing plays a critical role with respect to the health of the national economy. In 2005, housing's contribution to gross domestic product (GDP) was equal to over two trillion dollars or approximately 16.7 percent of GDP. In addition to the direct benefits of housing itself, the economic activity connected to the housing industry generates jobs for workers, future wealth for American families, and an important tax base for government.

The U.S. housing market experienced historic "boom" conditions during most of the 2004-2005 period, but home sales and housing production are now at historic lows. A variety of economic and market-based factors have come together in the "perfect storm" to significantly weaken the housing sector and endanger its benefits to families, local communities and the national economy. Total housing starts have fallen 34 percent from 2005, with steeper declines expected in 2008. Housing prices are falling in nominal terms for the first time in decades.

Home builders, who in past years have been a source of job creation and tax revenue, are now reporting losses and struggling to obtain capital resources. Consequently, housing has swung from being a powerful engine of economic growth to becoming a significant drag on the economy. Furthermore, home builders themselves, especially the large, national builders, are experiencing major losses. A recovery to profitability for the home building industry is not expected soon, which threatens jobs and the overall health of the economy.

To counter the negative effects of the mortgage crisis and ensure the long-term economic health of homeowners, the housing industry, and the national economy, NAHB recommends the following Congressional actions within the jurisdiction of the Finance Committee:

- ***Eliminate the Phantom Income Tax on Mortgage Debt Forgiveness***
- ***Expand the MRB Program to Allow for Mortgage Restructuring***
- ***Expand the Carryback Period for Net Operating Loss Deductions***
- ***Make Permanent the Deduction for Mortgage Insurance***
- ***Establish a First-Time Homebuyer Tax Credit***

The combination of these recommendations will play a critical role in stabilizing the housing markets and housing finance system while also ensuring a sustainable long-term recovery.

Causes of the Housing Market Crisis

The roots of the current housing downswing originate from events that occurred before the housing boom of 2004-2005. The boom itself was caused by the monetary stimulus enacted by the Federal Reserve to fight the threat of price deflation in the U.S. economy and as corrective policy that occurred in the wake of September 11th. The Federal Reserve dropped the federal funds rate to one percent in mid-2003 (a negative "real" rate), where it remained until the middle of 2004. Then the Fed increased interest rates until early 2006. The stimulus provided by the Fed, combined with low interest rates internationally, kept long-term interest rates in the U.S. at historic lows during most of the period spanning 2003-2005. This extremely favorable financing environment fueled buying activity in the interest rate-sensitive housing sector, pulling some demand forward in time 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. This 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, investors/speculators entered the single-family and condominium markets due to an expectation of strong capital gains.

The mortgage lending community also contributed to the housing boom, marketing a wide range of "exotic" Adjustable Rate Mortgages (ARMs) that were designed to help prospective buyers (including those considered 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 concerns about overly aggressive mortgage lending practices, particularly payment-option ARMs that permit negative amortization, but these concerns apparently had little influence on lending practices in either the regulated or unregulated markets.

The accumulation of large house price increases began to weigh on housing affordability measures by the early part of 2004, despite the low interest rate structure. However, proliferation of the "exotic" ARMs kept many prospective homeowners in the market, particularly in relatively high-priced metropolitan areas. Meanwhile, home sales and house price appreciation kept rising throughout 2004 and into 2005 while 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 2005.

The combination of declining demand on the part of prospective homeowners and a pipeline of housing supply that still was moving ahead quickly changed the market dynamic. What was previously a "sellers' market" became an environment where inventories were climbing and buyers became more cautious. It was at this time that many investor-owners of housing units scaled back their purchases, began cancelling sales contracts before closing, and even started reselling vacant, recently purchased homes.

Moreover, weakness in the housing finance sector, in part connected to some failures associated with the new lending practices described above, contributed to additional pain to the housing market. Many ARM loans made during the 2004-2006 period were extended to nonprime borrowers, whether or not they were bona fide homeowners or investors/speculators that often falsified their intentions. The ARM structures generally featured deeply discounted initial interest rates ("teasers"), interest-only payment schedules, or payment-option contracts allowing monthly payments smaller than accrued interest (negative amortization). Furthermore, the nonprime ARM loans often embodied dangerous risk-layering practices such as "no-doc" features that waived verification of borrow income and debt ratios (also called "liar loans"), as well as "piggyback" second mortgages that commonly took combined loan-to-value ratios up to one hundred percent.

The proliferation of weak lending standards was facilitated by a complex mortgage credit system that expanded the distance – in terms of information – between the arrangers of financing and the investors that ultimately held the mortgage-backed assets and bore the credit risk. The system involved mortgage brokers and mortgage bankers, conduits that packaged mortgages into exotic securities structures, financial rating agencies that were supposed to advise the investment community about the quality of the securities, and investors in the U.S. and abroad that were attracted by the promise of significant returns on mortgage-related securities.

Current Conditions

The mortgage credit system continued business as normal until early 2007 when house price appreciation faltered and subprime ARMs began to default in large numbers. These loans quickly were joined by "Alt-A" ARMs (a step or two above subprime), while it also became clear that the performance of securities backed by "prime" piggyback second mortgages was deteriorating badly as well, thereby threatening the quality of the first mortgages underneath. Investors began doubting the value of complex mortgage-related securities that they owned. The securities markets then froze, starting with subprime and Alt-A ARMs and quickly spreading to the jumbo ARM market (loan sizes above the conforming loan limit for mortgages eligible for purchase by Fannie Mae and Freddie Mac).

With securities markets operating seriously below-capacity, and with traditional portfolio investors out of the market, mortgage brokers could not broker and mortgage originators could not originate. The result was a credit crunch in large parts of the U.S. mortgage market. This produced a serious reduction in housing demand, which hit the housing market after a short period in early 2007 during which it appeared the housing market had partially stabilized. The further reduction in demand has produced housing prices declines and increased housing inventory.

The severe credit market crisis that erupted in August eased to some degree in October, but access to financing was made more difficult in recent weeks as a number of large financial institutions reported large credit losses and substantial write-downs of mortgage portfolios containing subprime and Alt-A home mortgages. Indeed, the deterioration of mortgage credit quality has produced a rush to quality, not only in mortgage-related securities markets, but also in corporate bond markets. Recent Federal Reserve surveys show that commercial banks have substantially tightened lending standards in all major components of the home mortgage market, including the prime conforming and jumbo loan components. Standards also were tightened on commercial real estate loans, a category that includes nonresidential mortgages as well as construction and land development loans for residential and nonresidential production.

The flight to quality in credit markets naturally is putting strong downward pressure on risk-free Treasury rates, helping to hold down required yields on prime conforming mortgages (salable to Fannie Mae and Freddie Mac), and federally-insured FHA loans are increasing. Even considering these limited benefits, it is likely that overall mortgage credit conditions will tighten further as house prices remain under downward pressure and mortgage delinquencies and foreclosures continue to increase through 2008.

Despite swift builder reactions to an abrupt credit-related downshift in home sales during the third quarter of 2007, inventories in the hands of home builders and vacancies in the stock of new and previously owned homes are near historic highs. Thus, single-family and condo sectors still exhibit striking "buyers' market" conditions while rental market conditions have firmed up to some degree.

In view of the depth of the current housing downswing, housing production will remain below the demographically-based trend level for several years beyond the 2008. Indeed, it may be well into the next decade before the production of new housing units (including manufactured homes) approaches the NAHB estimate of the average annual pace for the 2006-2015 period (about 2.0 million units). In retrospect, the finance- and price-driven acceleration of buying for homeownership and investment purposes pushed housing market activity to unsustainable levels during the boom. The housing market is now experiencing a "payback" in the demand for homeownership, following the surge that pulled demand forward into the boom years.

Economic Consequences

As noted earlier, housing played a pivotal role as a contributor to economic growth during the boom period, with housing accounting for more than sixteen percent of GDP in 2005. The decline in housing has resulted in a subtraction of approximately one percentage point from GDP growth during 2007. From the peak of the market in 2005, total housing starts have declined from over 2 million to about 1.3 million units in 2007. New single-family home sales have declined from nearly 1.3 million in 2005 to about 800,000 in 2007. Taken together with forecasts for weak GDP growth in 2008, the current state of weakness in home building may push the national economy into recession. NAHB's economic forecast currently calls for a 40-percent probability of a recession in 2008.

There are many economic impacts from the weakness in the housing markets. For home builders, much of the industry is currently experiencing historic business losses. NAHB's index of home builder confidence the (the NAHB/Wells Fargo Housing Market Index or HMI) now stands at a record low of 19, dramatically underscoring that builders are not confident about the prospects of the housing market in the coming year.[1] Ongoing business losses among builders threaten the financial health of the industry and may ultimately result in bankruptcies. In addition to the effects this would have on the owners of these firms, business losses threaten jobs, including jobs that were created earlier in the decade when the rest of the economy was struggling and housing led the way. The Bureau

[1] The HMI index measures home builder expectations of future market activity and ranges from zero to one hundred. Values above fifty indicate a positive view of the marketplace.

of Labor Statistics reports that the residential construction industry has experienced 55,000 net lost jobs in the last twelve months, or about 5.5 percent of the total work force. The construction industry as a whole lost 24,000 net jobs in November alone. Given the forecast for reduced home building activity in 2008, these job losses are expected to grow significantly.

Moreover, because of the boom in housing, home builders have record inventories of new homes-for-sale and land on their balance sheets. Managing this excess inventory of homes and land is the primary economic challenge for the industry, and perhaps the national economy, in the months to come. In fact, Alan Greenspan recently stated that, "the critical issue on the whole subprime, and by extension, the international financial system, rests very narrowly on getting rid of probably 200,000-300,000 excess units in inventory."[2]

Excess inventory of housing units has placed severe pressure on housing prices. The S&P Case-Shiller National Home Price Index reports that housing prices are down 4.5 percent on annual basis. Prices in some local markets in Florida and California may have declined by as much as 15 percent in recent months. Futures markets of housing price expectations indicate that prices may continue to fall, with average national prices down 10 to 25 percent from peak to trough.

Another consequence of the weakness in the housing market is a sharp increase in foreclosure activity. Not surprisingly, the climb in delinquencies and foreclosures has been most severe in subprime loans, with subprime ARMs showing the steepest rise. Subprime mortgage loans accounted for over one-half of foreclosures in 2006 and the first half of 2007. The Mortgage Bankers Association's National Delinquency Survey for the third quarter of 2007 showed rising delinquency and foreclosure rates across all loan types.

The overall delinquency rate stood at 5.59 percent of all loans outstanding in the third quarter, up 92 basis points from a year earlier and the highest level since 1986. The percentage of loans in the foreclosure process was 1.69 percent, up 64 basis points from the year before. The rate of loans entering the foreclosure process was 0.78 percent, up 32 basis points over the past 12 months. Both third quarter foreclosure measures were the highest levels ever recorded in the MBA survey. For subprime mortgages, the delinquency rate hit 16.31 percent, up 375 basis points from a year ago. The rate of subprime loans in foreclosure registered at 6.89 percent, up 303 basis points from the third quarter of 2006, while the rate of subprime loans going into foreclosure was 3.12 percent, a 130 basis point increase from the year before.

The outlook for mortgage delinquencies and foreclosures is grim due to the bulge of mortgages resetting from teaser to fully indexed interest rates over the next two years. The Federal Deposit Insurance Corporation (FDIC) estimates that 1.5 million ARM loans with outstanding balances of $330 billion are scheduled to reset between September 2007 and December 2008.

Foreclosures are both a cause and an effect of declining housing prices. Reduced demand for housing has resulted in declining housing prices, which has left some homeowners with debt in excess of the market value of their home. It is difficult to refinance such "underwater" properties, which can lock these homeowners into mortgages that are scheduled to reset to payments the homeowner cannot make. This in turn results in more foreclosures, which puts more homes-for-sale onto the market, thereby reducing housing prices. Unless broken, this process can produce a vicious cycle of foreclosures and falling housing prices.

While declining housing prices improves housing affordability, particularly for first-time home buyers who recently were priced-out of the market, overall housing price declines represent a substantial decline in wealth for American households. For most families, the home is the most important source of wealth and savings. Furthermore, declines in housing prices, and therefore wealth, can be linked to consumer behavior. When families experience a drop in wealth, they restrain spending in order to save more. The Congressional Budget Office recently reported that a 10-percent decline in housing prices could result in a decline in consumer spending of $55 billion to $191 billion.[3] The direct effect on GDP growth would be between 0.4 and 1.4 percentage points of lost growth. The worst case analysis of CBO indicated reduced consumer expenditures of approximately $300 billion and a 2.2 percentage point subtraction from GDP growth from falling housing prices. Given the weakness in the overall economy and the

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[2] *Dow Jones International News (11/05/07)*

[3] Housing Wealth and Consumer Spending. Congressional Budget Office. January 2007.

possibility of a recession, these are sobering estimates that suggest government housing and tax policy can aid the eventual long-term recovery.

Tax Policy Recommendations

NAHB recommends that Congress enact the following tax proposals to ensure the existing problems in the housing market identified in this statement do not persist, thereby threatening the economic health of homeowners, builders and the economy as a whole.

Eliminate the Phantom Income Tax on Mortgage Debt Forgiveness

In October of 2007, the House of Representatives approved H.R. 3648, *The Mortgage Debt Forgiveness Debt Relief Act of 2007*, a bill to eliminate the income tax consequences from the forgiveness of mortgage debt associated with a principal residence. NAHB supports H.R. 3648 – and its companion legislation in the Senate, S.1394, *The Mortgage Cancellation Relief Act of 2007*, introduced by Senators Debbie Stabenow (D-MI) and George Voinovich (R-OH) – as a means of encouraging struggling homeowners to seek mortgage restructuring with lenders in order to prevent foreclosure.

Section 108 of the Internal Revenue Code requires any discharge of indebtedness (credit cards, student loans, mortgages, etc.) to be includable in taxable income. There are several possible scenarios in which this tax effect arises in the context of mortgage loans however the key components are the same for all. A bank forgives some amount of indebtedness for a homeowner either to avoid foreclosure or simply to forgive debt to a homeowner already in the foreclosure process. In general, the amount of forgiven indebtedness is treated by the Internal Revenue Service (IRS) as income which is then taxable at ordinary income tax rates. For families already struggling to make the ends meet, the phantom income and resulting tax burden generated by Section 108 can endanger their financial health even further.

Section 108 requirements also create perverse incentives in the marketplace. First, the existing tax rules encourage many struggling homeowners (specifically those in states with non-recourse debt as the primary mortgage model) to seek foreclosure over restructuring their loan with lenders. This moves more homeowners out of their homes, destabilizes neighborhoods and increases the inventory of the housing stock on market. Second, the potential increase in tax liability discourages homeowners who are solvent from seeking restructuring agreements from lenders, a preferred situation for all involved. H.R. 3648 and S.1394 would encourage market-based restructuring between lenders and homeowners and discourage foreclosures. This is consistent with the Department of the Treasury efforts to encourage mortgage restructuring under the "HopeNow" Alliance.

Expand the MRB Program to Allow for Mortgage Restructuring

The Administration recently asked Congress to temporarily modify and expand the Internal Revenue Code Section 143 Mortgage Revenue Bond (MRB) program. Under the proposal, state and local governments would be able to issue tax-exempt bonds to finance mortgage restructuring efforts. This would be accomplished by modifying Section 143 to waive the first-time homebuyer requirement, thereby expanding the set of homeowners the program can help. NAHB supports the intent of this proposal as a means of helping owners of principal residences who are struggling to make their monthly housing payment. NAHB recommends that to achieve this policy objective, Congress should provide for a special, temporary allocation of mortgage revenue bonds, distinct from the existing Section 146 Private Activity Bond volume cap. Further Congress should instruct the IRS to waive as necessary the safe-harbor housing purchase price amounts published annually for the purpose of the special allocations of MRBs.[4]

Expand the Carryback Period for Net Operating Loss Deductions

For home builders, who face a severe economic downturn and increasing challenges in the credit markets, the importance of the ability to claim and carry back net operating losses [NOL] deductions cannot be overstated. The ability to carryback NOLs to years when significant taxes were paid provides financial resources to businesses

[4] IRS Revenue Procedure 2007-26.

facing difficult economic decisions concerning employment and community development. In the short-term, cash refunds resulting from NOL carryback claims may be the most significant source of funds for these businesses.

Under present law, Section 172 of the Internal Revenue Code allows taxpayers to carryback NOLs to the two preceding tax years with any remaining losses carried forward for twenty years following the year of the loss occurred. There are sound economic and tax policy justifications for allowing a carryback of NOLs. Carrybacks of NOLs are an important part of the government's fiscal policy toolbox. Carrybacks act as automatic stabilizers, reducing tax burdens when the economy weakens. Carrybacks and carryforwards also allow the proper taxation of net income for business for which income and costs are not realized evenly within and across tax years. The objective of businesses is to maximize the present value of lifetime income --- not to maximize calendar year net income for tax considerations. For industries like home building and long-term manufacturing, revenue may be realized in different years than costs, thereby resulting in an effective tax rate that is significantly higher than the statutory rate.

For example, home builders are facing a significant problem with respect to their home and land inventories. Due to the significant decline in sales, builders have had to sharply reduce production and are being pressured to reduce inventories to generate cash to keep their businesses viable. Nonetheless, disposing of existing inventory remains a challenge. Selling homes and land at significant losses will increasingly result in large NOLs. However, without the ability to carry back the NOLs to years of profitability – for example to 2004-2005, the housing market boom years – home builders will be required to carry forward a large amount of their NOLs, thereby eliminating the possibility of generating cash from tax years when builders had previously paid significant taxes.

The inability to recover cash from the carryback of NOLs will result in the need to either increase high-cost borrowing or require further liquidation of land and homes, which will compound the challenging situation builders are currently facing. The additional supply of homes and land on market for sale, of course, will put even more downward pressure on prices and further add to the home building crisis. The result of this will be more layoffs of workers and reduced development of communities. Expanding the two-year carryback to four or five years will significantly help the sector with respect to cash requirements to weather the current downturn. To offset this change, a corresponding reduction in the twenty-year carryforward may be appropriate.

Make Permanent the Deduction for Mortgage Insurance

House bill H.R. 3648 also contains an eight-year extension of the private mortgage insurance (PMI) deduction, presently set to expire at the end of 2007. Under present law, Section 163(h)(3)(E) treats PMI, Veterans Administration, and Federal Housing Administration, and Rural Housing Administration mortgage insurance payments as deductible amounts, similar to mortgage interest payments, for mortgage insurance issued after January 1, 2006. The deduction is also subject to an income phase-out that precludes this deduction for married taxpayers with an adjusted gross income of more than $110,000. Nonetheless, the extension of the PMI deduction will encourage homeowners to obtain less risky mortgage products, thereby reducing the need for loss mitigation efforts in the future. The provision will also have a long-run benefit on government revenues, as the flow of deductible mortgage interest payments will be smaller with more PMI participation, as this reduces the use of higher interest second-liens or so-called "piggyback mortgages."

Establish a First-Time Homebuyer Tax Credit

One problem that remains in the housing market despite recent pullbacks in housing prices is the challenge of housing affordability for first-time homebuyers. The housing market has experienced a declining homeownership rate for the first time in nearly 15 years. As of the third quarter of 2007, the homeownership rate stood at 68.2%, down from 69.2% in the second quarter of 2004. Many of the buyers who have been edged out of the home buying market are first-time buyers, particularly given the tightening requirement for mortgages in recent months. Providing housing to first-time buyers is helped by declining prices, but clearly falling prices hurt existing homeowners, particularly those who depend on housing wealth as their primary source of savings. An economically efficient means of stimulating demand without generating the negative macroeconomic consequences of improved housing affordability through deep price declines can be accomplished through the establishment of the a first-time homebuyer tax credit. Under present law there exists a limited version of such a proposal. Section 1400C provides a tax credit of up to $5,000 for first-time homebuyers who purchase a residence in the District of Columbia. A national version of such a tax credit would help first-time home buyers, help reduce inventories, and fight falling house prices.

Conclusion

NAHB applauds the Committee for holding this important hearing and exploring both the causes and solutions to the current mortgage crisis. The issues at hand are manifold and we urge the Committee and the Senate to act swiftly before the crisis deepens and more American families fall victim to it. We look forward to collaborating with the Congress to craft solutions that keep families in their homes, protect local communities and restore the critical contribution of housing to our national economy.