Testimony of

Alex J. Pollock
Resident Fellow
American Enterprise Institute

To the Committee on Financial Services
U.S. House of Representatives

Hearing on Housing Finance—What Should the New System Be Able to Do?

April 14, 2010

Seven Steps Toward Sound Mortgage Finance

Mr. Chairman, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI, I was the President and CEO of the Federal Home Loan Bank of Chicago from 1991 to 2004, and I am a Past-President of the International Union for Housing Finance. I have both professionally lived through and studied important transitions in mortgage finance, including of course, the one we are now in the midst of.

This morning I would like to propose for your consideration seven steps toward sound U.S. mortgage finance in the future:

-Create a private secondary market for prime, conforming mortgage loans

-Transition to no GSEs

-Facilitate credit risk retention by originators

-Develop countercyclical strategies

-If there should be surviving GSEs, do not use government-insured banks to promote their finances

-Develop clear, straightforward key information for borrowers

-Reintroduce savings as an explicit goal of mortgage finance.

1. <u>Create a private secondary market for prime, conforming mortgage loans</u>

The future mortgage finance system should have a robust private secondary market for the largest segment of the business: prime, conforming mortgage loans. In this market, private investors should put private capital at risk, and prosper or lose as the case may be. This is the most obvious case where the risks are manageable and no taxpayer subsidies or taxpayer risk exposures are required or desirable.

There may decades ago have been a case for GSEs (Fannie Mae and Freddie Mac) to guarantee the credit risk of prime mortgage loans in order to overcome the geographical barriers to mortgage funding, which were created by government regulation. There was lately a case for using GSEs to get through the financial crisis which they themselves did so much to exacerbate. But as we move into the future mortgage finance system, the prime mortgage market should stand on its own. Covered bonds, as well as securitizations, might well be part of this evolution.

A private secondary market for prime mortgages should have been a natural market development. Why did it never develop? The answer is obvious: no private entity could compete with the government-granted advantages of the GSEs. There could be no private prime conforming mortgage loan market while they used those advantages both to make private competition impossible, and to extract duopoly profits ("economic rents") from the private parties.

That element of the old housing finance system should not survive.

2. <u>Transition to no GSEs</u>

The old GSE duopoly could be taken out of the prime market by limiting GSEs' activity by regulation—but a better and more direct solution is to structure a transition to a world of no GSEs. I would like to commend Congressman Hensarling's bill, the "GSE Bailout Elimination and Taxpayer Protection Act" (HR 4889), for suggesting how this might be done, and how an orderly transition might actually be put in gear.

Housing finance inflation was at the center of the financial crisis, and the GSEs were at the center of housing finance inflation. No mortgage system reform can be meaningful which fails to address Fannie Mae and Freddie Mac, as I think everyone now agrees.

In my view, this is the core issue: You can be a private company, with market discipline; or you can be part of the government, with government discipline. But you can't be both. Trying to be both, in other words, a GSE, means you avoid both disciplines. Fannie and Freddie, or parts of Fannie and Freddie, should become one or the other.

A large part of them should become a private company competing, sink or swim, in the secondary prime conforming market, with zero special advantages. The part of Fannie and Freddie which makes non-market loans and provides housing subsidies should be merged into the structures of the Department of Housing and Urban Development, subject to the normal government disciplines of the budget and appropriations.

The desired transition is somewhat easier at the moment because Fannie and Freddie are not now GSEs. They are government housing banks, owned for the most part and controlled entirely by the government.

Therefore in my opinion, it is quite clear that, as recommended by the Congressional Budget Office, they should be on the federal budget. Fair and transparent accounting seems to demand that they not get off-balance sheet accounting treatment, which comes in for so much criticism in other areas. In this context, I would also like to commend Congressman Garrett's bill, the "Accurate Accounting of Fannie Mae and Freddie Mac Act" (HR 4653).

3. <u>Facilitate credit risk retention by originators</u>

The retention of credit risk or "skin in the game" in mortgage finance is a lesson drawn by a great many observers from the mistakes of the bubble. In my view, there is indeed a fundamentally important idea here (which I did a lot of work on starting in 1994). What should be more natural to ask of someone creating and then wishing to sell you credit risk than, "How much are <u>you</u> keeping?"

I propose that the retention of credit risk by mortgage originators should be facilitated, but not required, by public policy. One size is very unlikely to fit all, and the painful risks of "originate to sell" models are unlikely to be forgotten for several years. During that time, we should bend our efforts to make sales with originator credit retention, in various forms as the market develops, a real and robust alternative. I believe many investors will prefer such loans and they may well command premium prices. We should focus on removing the regulatory and accounting obstacles to this healthy development.

I believe the essential locus of credit risk retention is the originator of the loan—the place at which the credit decision is made and controlled. Naturally, some originators will provide enhancements which are more credible than others. What we want is the market always asking about this factor.

4. <u>Develop countercyclical strategies</u>

Financial cycles, particularly in real estate, are inevitable. But they could be moderated by developing countercyclical elements to the mortgage finance system. This is one of the most important things we could do.

Two promising ideas of this kind are countercyclical loan-to-value ratios (LTVs) and bigger (countercyclical) loan loss reserves in good times.

Bubbles involve an unstable positive feedback loop between asset prices and credit availability. For a possibly extended period of time, as in the 21st century housing bubble, higher asset prices (of houses, in this case) call forth more aggressive lending with higher LTVs, and more aggressive lending allows buying which drives the price of the asset higher. This cannot last forever, of course, but it can last a number of years.

As asset prices inflate higher and higher in a boom, the risk of loans seems to be decreasing, when in fact it is increasing. As assets prices go further and further above their trend line, the risk of their subsequent fall is becoming greater and greater. The logical and necessary thing to do is to reduce the amount being lent against the current market price of the asset.

But what generally happens in fact is the exact opposite: with increasing optimism, LTVs rise instead of being reduced. "Innovative" low down payment and no down payment mortgages, for example, are promoted and made, and are politically popular. This helps inflate the credit bubble further, ensuring that the inevitable bust will be worse.

In short, we need to create a mortgage finance system in which LTVs fall and down payments increase as asset prices inflate—then we would have countercyclical LTVs.

Congressman Foster, in a very interesting discussion, has pointed out that the desired countercyclical LTV behavior is like a feedback controller in engineering theory—it is like a governor on an engine. He has proposed some simple mathematical ways that inflating asset prices might define lower LTV requirements. This part of the problem is key, but it is easier than to get the idea actually implemented in time for the next boom. It is clear that something along these lines would be extremely beneficial.

Turning to loan loss reserves, as now mandated, they are procyclical. Successful private risk bearing requires the opposite of our current accounting: specifically, much bigger loan loss reserves should be created in the good times. This is required, because it is in the optimism of the good times that you are making the bad loans that will later haunt you.

With bigger, more old-fashioned loss reserves, we can do better in the next cycle.

5. <u>If there should be surviving GSEs, do not use government-insured banks to promote their finances</u>

If we do not succeed in transitioning to no GSEs, and Fannie and Freddie survive in some GSE form, an essential reform to prevent financing them from being promoted through the regulations and capital rules of the banking system. Banks have been encouraged through government policy to invest in GSE preferred stock, unsecured debt and MBS.

This channels government-insured deposits into GSE balance sheets. It is double-dipping on the government guarantee and a doubling down on the financial system's concentration in real estate risk.

I suggest that in a continuing GSE world, banks should have to hold 100% equity against equity investments in GSEs, and that exactly the same concentration limits on unsecured credit to one entity be applied to GSEs as to any other debt issuer.

6. Develop clear, straightforward key information for borrowers

I have spoken this Committee too many times on the need for a one-page key mortgage information form for a repetition to be welcome. I continue to think that making sure borrowers have clear, simple and straightforward information about the commitments they are making will enable informed decision-making, greater personal responsibility by all parties, and a better mortgage finance system.

7. Reintroduce savings as an explicit goal of mortgage finance

Savings and loan associations were once central providers of mortgage finance. But the original leaders of the "movement," as it then was—for they considered themselves a movement for personal and social improvement—were very clear about the order of things: first the savings, then the loan.

Our subsequent political development seems to have forgotten about the "savings," and put all the emphasis on the "loan." Even savings in the form of building up equity in the house by retiring the mortgage loan has turned into ways of extracting the equity instead.

A successful mortgage finance system of the future will find ways to rediscover and reemphasize thrift and savings. This sounds old-fashioned, and of course, like all the other eternal verities of financial prudence, it is.

Thank you again for the chance to share these views.