Testimony of

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Regulatory Implications of the Housing and Mortgage Bubble and Bust

Mr. Chairman, Ranking Member Saxton, Vice Chair Maloney 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 in 2004, I spent 35 years in banking, including 12 years as President and CEO of the Federal Home Loan Bank of Chicago. I am a director of three financial services companies and a Past President of the International Union for Housing Finance. I have both experienced and studied many credit cycles, of which our 21st century housing and mortgage cycle is the latest example.

The Human Foundations of Financial Risk

The severe housing and mortgage bust we are experiencing can best be understood as the inevitable deflation of a classic asset bubble. Historically speaking, why do we keep having these financial adventures, no matter what our technological and theoretical progress or regulatory reorganizations? Why is "a prudent banker one who goes broke when everybody else goes broke"? This witty line of Keynes points us to the eternal human elements behind the credit overexpansion that our sophisticated, globalized, computerized, and leveraged markets produced between 2003 and 2006, the subsequent debt panics of 2007 and 2008, and the continuing bust.

The losses of the bust are now being recognized in the general, "Main Street" banking system. Note in this context that 48% of the total loans of insured depositories are based on real estate. For the vast majority of banks, those with total assets of less than $1 billion, this number is 67%.

The human nature behind the bubbles and busts does not change, whether the calculations of boundless future profit from increased leverage are made with quill pens or advanced computers. Credit overexpansions are always based on a belief—the first optimistic, and then euphoric, belief in the rising price of some asset class.

The belief in the ever-rising price of the favored asset seems to be confirmed on all sides as the bubble expands. As long as the underlying price, of houses in our current case, keeps rising, everybody wins—borrowers and lenders, brokers and investors, speculators and flippers, home builders and home buyers, rating agencies and bond salesmen, realtors and municipalities, and many others. Bubbles are notoriously hard to control because so many people are making money from them while they last.

Political actions also play a role. In the housing bubble, politicians if both parties also thought they were winning as all sides cheered increasing home ownership ratios and expanding "access" to mortgage credit with lower credit quality loans. The government has been an effective promoter of higher loan to value lending and smaller down payments—such as recent proposals to move the FHA to 100% LTV loans—riskier lending, and the use of government guarantees. A 1994 "National Homeownership Strategy," for example, advocated "financing strategies, fueled by creativity" for those to become home buyers who lack the cash or income to buy a home. A good deal of "creativity" was indeed subsequently applied.

Of course, bubbles always come to a sad end. Retreating eastward after the collapse of the bubble in Kansas land prices in the 1880s, defaulted farm mortgage borrowers put on their wagons: "In God we trusted, in Kansas we busted."

This time expectations of house price increases entered the models analyzing subprime mortgage pools as "HPA," or house price appreciation. What ultimately emerged was naturally HPD: house price <u>depreciation</u>. So we can update the Kansas motto of 120 years ago to: "In HPA we trusted, with HPD we busted."

Can regulation avoid these cycles?

<u>Was There a Regulatory Golden Age?</u>

Some current discussions give the impression that there used to be a time when highly regulated banks dominated the credit system, so regulators prevented problems. Was there such a "golden age" of regulation? No, there wasn't.

In the 1960s, federal regulation of deposit interest rates (the infamous "Regulation Q"), which can be viewed as having created a government-sponsored deposit cartel, caused two severe credit crunches—those of 1966 and 1969, in which mortgage credit would get rationed out.

Consider the mid-1970s, when commercial bank lending created a bubble and massive bust in loans to real estate investment trusts ("REITs"). The Senate Banking Committee held hearings wondering whether the entire commercial banking system was insolvent on a mark-to-market basis. (Needless to say, the banks did not mark their assets to market.)

Savings and loans were then the most intensely regulated of financial institutions. The result? By 1979, by following their fixed rate lending regulatory instructions, in the aggregate they were insolvent on a mark-to-market basis. The insolvency of the savings and loans laid the foundation for the move to mortgage securitization.

How about the 1980s? Well, more than a thousand commercial banks failed in this decade. There were massive credit busts in loans to developing counties ("LDCs" in the jargon of the time), in energy finance, and again in commercial real estate loans. In all cases, we are speaking of loans on the balance sheets of the banks. The insolvency of the saving and loans grew much greater, causing the insolvency of their federal deposit insurer, "FSLIC," and of course ending in collapse and bailout in 1989, along with regulatory reforms and restructuring.

In 1993, in the wake of these reforms, the financial historian Bernard Shull insightfully wrote:

> "Comprehensive banking reform, traditionally including augmented and improved supervision, has typically evoked a transcendent, and in retrospect, unwarranted optimism. The Comptroller of the Currency announced in 1914 that, with the new Federal Reserve Act, "financial and commercial crises or panics…seem to be mathematically impossible." Seventy-five years later, confronting the S&L disaster with yet another comprehensive reform…The Secretary of the Treasury proclaimed 'two watchwords guided us as we undertook to solve this problem: Never Again.'"

Yet here we are again. In the meantime Congress also imposed the expensive Sarbanes-Oxley Act to manage corporate risk. It was so successful that we have nearly had a global financial collapse.

The British formed a consolidated financial regulator, the "FSA," and separated its role from the Bank of England. But when the Northern Rock funding panic and crisis hit, this structure did not work well. No matter how you organize any government activity (or company or anything), as time goes by, you will have to reorganize it. The perfect answer does not exist. However you try to engineer a regulated market or industry, the reactions and adaptations to the regulatory engineering require another reform, and another, and so on ad infinitum.

My point is not that no action should ever be taken, but that we have to be realistic about the adaptations to and unforeseeable effects of all interventions. I am against utopian hopes for what financial regulation can achieve, but I am for sensible improvements.

Here are a number suggestions for such improvements:

-Simple and straightforward disclosure in one page

-Remove government support for rating agencies

-Encourage credit risk retention by mortgage originators

-Countercyclical management of LTV ratios

-The "Super Fed"

-Increased GSE responsibility for refinancing the bust

-Controlling "fair value" accounting

-The study of financial history

I will discuss each briefly.

Simple and Straightforward Disclosure in One Page

I have previously testified to this Committee that we should require a clear, straightforward, one-page disclosure to borrowers of the essential information about prospective mortgage loans. The information, in regular-sized type, should focus on what commitments the borrowers are making and how much of their household income these will require, so they can "underwrite themselves" for the credit. This would be a major improvement in the American mortgage finance system.

Mr. Chairman, thank you for introducing S. 2296, which would implement this idea, which everybody should be able to agree on. I hope it will be included in any final mortgage legislation.

And thank you, Vice Chair Maloney, for your interest in the possibility of using the one-page approach in another area, overdraft disclosures.

Remove Government Support for Rating Agencies

The credit rating agencies say that they are in the business of publishing opinions about the future. In this I believe they are right, and I have a good deal of sympathy with the thought that in the course of financial events, some such opinions will prove to have been mistaken, even disastrously mistaken. So when it comes to opinions about the future, more opinions and competition is likely to uncover new insights into credit risks and new methods of analysis.

A particularly desirable form of increased competition would be from ratings agencies paid solely by investors, as opposed to those paid for by the issuers of securities, as many commentators have suggested.

But here is a larger question: Since all opinions are liable to error, and opinions based on models are liable to systemic error of vast proportions—as the subprime bust makes apparent—why should the U.S. government want to enshrine certain opinions as having preferred, preferential, indeed mandatory, status? It shouldn't.

I suggest that all regulatory requirements to use the ratings of certain preferred rating agencies be eliminated. Banks and other regulated investors should instead be responsible for developing their own prudent standards, which would probably entail the use of credit ratings as part of a credit management system—but without government sponsorship of the dominant firms.

Encourage Credit Risk Retention by Mortgage Originators

One of the lessons of the savings and loan collapse was that for depository institutions to keep long-term fixed rate mortgages on their own balance sheet, while funding them with short-term deposits, was extremely dangerous in terms of interest rate risk, although it was no problem in terms of credit risk. The answer was to sell the loans to bond investors through securitization and divest the interest rate risk to those better able to bear it. As a side effect, the credit risk was also divested.

In the wake of the mortgage bubble and bust, we now realize that divesting the credit risk created big problems on its own, breaking the alignment of incentives between the lender making the credit decision and the ultimate investor actually bearing the credit risk. Some commentators have referred to the good old days when the savings and loans kept the loans themselves—how short the memories are of the disaster that caused.

The right synthesis of the historical lessons is for securitization to continue to address interest rate risk, while encouraging the retention of significant credit risk by the original mortgage lender. There are numerous regulatory and accounting obstacles to this approach, but its obvious superiority makes it worth while to try to overcome them. This is an assignment which should be given to an appropriate group of financial regulators.

<u>Countercyclical Management of LTV Ratios</u>

As asset prices rise in a bubble, more debt and leverage always seems better. The credit experience of loans financing the inflating asset will be good, with delinquencies, defaults, and losses all low. Thus, the risk of the loans seems to be decreasing, even while the risk is in fact increasing.

The low delinquencies and defaults seem to confirm the success of the credit expansion and the accuracy of the lending models. Loan-to-value (LTV) ratios rise, even while they should be being reduced. "Innovative" no-down-payment mortgages are promoted. This inflates the price and credit bubble further, and insures that the ensuing bust will be worse.

A rational, countercyclical management of LTV behavior would reduce LTV ratios as the price of the asset inflates beyond its trend—this is the opposite of what in fact occurs. How one might make this happen should be the subject of another study.

<u>The "Super Fed"</u>

I believe the "Super Fed" idea contained in the Treasury Department's restructuring proposal is consistent with the original situation in 1913, the year of the Federal Reserve Act, as well as the current financial world. This idea would have the Fed serve as stability, systemic risk overseer and lender of last resort to the financial markets in general.

Much has been made of the Fed's extending discount window lending to investment banks, rather than only to commercial banks. But separation of banking into these two parts did not occur until the Glass-Steagall Act of 1933. In 1913, for example, J.P. Morgan and Co. was still both an investment bank and a commercial bank; it did not divide into Morgan the commercial bank and Morgan Stanley the investment bank until forced to in 1935.

Today Morgan is again both a commercial bank and an investment bank, after the repeal of Glass-Steagall in 1999, and will be even more so with its pending acquisition of Bear Stearns, as arranged by the Fed. The "Super Fed" proposals seems sensibly to deal with the financial structures of the present and the future, as opposed to those of 1933-1999.

<u>Increased GSE Responsibility for Refinancing the Bust</u>

As I have previously testified to this Committee, it seems to me that in exchange for the manifold advantages Fannie Mae and Freddie Mac receive from the government, they should be assigned a larger role in refinancing the troubled loans of the mortgage bust.

Controlling "Fair Value" Accounting

I know Congress does not like to get involved in the theoretical—one could say the metaphysical—disputes of accounting. Still, the current accounting fashion of "fair value" accounting has played an important role in the financial problems of the last ten months. There is no doubt in my mind that "fair value" accounting is pro-cyclical, that it accentuates reported losses in times of financial panic and helps encourage the boom in times of optimism. Is there some way to control its perverse effects?

Among the key questions which must be addressed are:

-What does a "market price" mean when there is no market?

-Should panicked levels of fear and uncertainty determine accounting results?

-Should accounting be about the recording of cash flows over time or the theoretical buying and selling of assets and liabilities?

I don't suggest that it is easy to answer such questions, only that they are in fact legitimate policy issues.

The Study of Financial History

"The mistakes of a sanguine manager are far more to be dreaded than the theft of a dishonest manager," wrote Walter Bagehot. The best protection against excessively sanguine beliefs is the study of financial history, with its many examples of how easy it is to be plausible, but wrong, both as financial actors and as policy makers. Perhaps we need a required course in the recurring bubbles, busts, foibles and disasters of financial history for anyone to qualify as a government financial official. I have the same recommendation for management development in every financial firm.

Thank you again for the opportunity to share these ideas.