

Testimony of

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Refinancing the Mortgage Bust

Mr. Chairman, Ranking Member Shelby, 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 spent 35 years in banking, including twelve years as President and CEO of the Federal Home Loan Bank of Chicago. I am a Past President of the International Union for Housing Finance and a director of three companies in financial businesses.

In my career I have experienced many credit crises, such as the credit crunch of 1969; the real estate investment trust collapse of 1975; the oil, commercial real estate, and Less-Developed Country loan crises, as well as the savings and loan collapse, of the 1980s; the debt panics of the 1990s; up to the current and severe housing and mortgage bust, which continues its panicky downward course, with the risk of a major downside overshoot.

Context

The bust has followed inevitably, as the night follows the day, the great housing and mortgage bubble of the new 21st century. This time we apparently had the greatest house price inflation in American history, accompanied by the unsustainable expansion of

subprime credit, which both fed the house price increases and seemed to be justified by them. Bubbles are notoriously hard to control, because so many people are making money from them while they last. The price inflation stimulated the lenders, the borrowers, the mortgage brokers, the homebuilders, the realtors, the investors, the bond salesmen, the CDO designers, the speculators, the bond insurers, and the flippers. The value of residential real estate about doubled between 1999 and 2006, increasing by \$10 trillion. As Walter Bagehot so rightly observed in 1873:

“All people are most credulous when they are most happy, and when much money has just been made, when some people are really making it, when most people think they are making it, there is a happy opportunity for ingenious mendacity. Almost everything will be believed for a little while.”

Bagehot’s description certainly fits the developments of the subprime mortgage market.

To help encourage more moderate and rational housing finance behavior in the future, I believe an essential long term reform is to insure clear and straightforward disclosure to borrowers of what mortgage loans really mean to them and to their household income. I have proposed a one-page disclosure form, “Basic Facts About Your Mortgage Loan,” to achieve this, and would like to thank Senator Schumer for introducing S. 2296 with the same goal. I hope its provisions will be included in any mortgage legislation adopted by the Committee. It will mean fewer foreclosures in the next cycle.

As for this cycle, our recent bubble and the ongoing bust display all the classic patterns of recurring credit overexpansions and their painful aftermaths. Since this time the upside overshoot was so large, a correction is required, unavoidable and, as shown by many statistics we all know only too well, under way, but we should work to avoid a needlessly destructive self-reinforcing downward spiral.

It is evident that the current excess supply of houses, with the additional selling pressure from foreclosed properties, plus sharp curtailment of credit and reduced demand for

houses, means a trend of falling house prices. Informed forecasts suggest a national average drop of perhaps 15% over two or three years. The magnitude of the drop is uncertain, but the direction is certain. Unfortunately, falling house prices trigger higher mortgage defaults, as the house comes to be worth less than the amount owed. This is especially true when loans were made with small or no down payments, as they were, or were made to speculative buyers, as many were. Defaults are still rising in subprime mortgages, and rising in the Alt-A and prime sectors. As option payment mortgages reach their maximum negative amortization, they will join the parade. The expectations of house price appreciation have become the reality of house price depreciation, so defaults and foreclosures rise, which tends to reinforce the price declines.

We face the possibility of a self-reinforcing downward spiral of defaults, losses, credit contraction, falling house prices, foreclosures, greater losses, more credit contraction, further falls in prices, more foreclosures or what Chairman Bernanke has called a “financial accelerator.” To use a different term, the risk of a “debt deflation” in so large and important a sector as housing-mortgage finance, needs to be addressed.

At a recent discussion of the mortgage bust, a senior economist from an international institution intoned, “What we have learned from this crisis is the importance of liquidity risk.” “Yes,” I replied, “that’s what we learn from every crisis.” Indeed, the tendency of financial markets to re-learn the same lessons over time is remarkable. Can we learn from the history of mortgage crises? Yes.

The Home Owners’ Loan Corporation

A central lesson is that temporary interventions to ameliorate the probable overshoot of a downward cycle is a reasonable project with much historical precedent. A particularly suggestive analogy to our present foreclosure issues is presented by the history of the Home Owners’ Loan Corporation (“HOLC”), which was very useful in addressing the massive mortgage collapse and foreclosure crisis of the 1930s. This was preceded by the overconfident mortgage lending and borrowing of the 1920s, which featured interest-only

loans, balloon payments, frequent second mortgages, the assumption of rising house prices and the firm belief in the availability of the next “refi”. Sound familiar? Then came the defaults, foreclosures, and debt deflation. I believe the lessons of HOLC are again relevant and might be applied today.

HOLC was created by Section 4 of the Home Owners’ Loan Act of 1933, which took only three and a half pages of text. It was from the beginning understood as a temporary, emergency intervention to provide refinancing and liquidity based on the government’s credit, which would be withdrawn as normal market functioning returned.

The fundamental idea was that for three years (and only for three years) HOLC was to acquire defaulted residential mortgages from lenders and investors in voluntary transactions, thereby to avoid foreclosure and avoid adding properties to already overburdened markets, and then refinance the mortgages on more favorable and sustainable terms. The lender was relieved of a defaulted, non-earning asset, but often took a loss on the principal of the original mortgage, receiving less than its par value. This realization of loss of principal by the lender was an essential element of the reliquification program—as it should be today. It was, and would be, realization of a loss which, economically speaking, has already happened, but without the additional costs for all concerned of foreclosure. This was a refinancing, not just a modification of the loan.

The goals of the program were to:

- “Protect the small homeowner from foreclosure”
- “Relieve him of part of the burden of excessive interest and principal payments incurred during the period of higher values and higher earning power”
- “Declare that it was a national policy to protect home ownership”
- “Put the least possible charge on the federal Treasury”

- "Avoid injustice to the investor."

A pretty good list, I think.

HOLC's new loan to the refinanced borrower was limited to 80% of its appraisal of the value of the property, with a maximum of \$14,000 in 1933 dollars. With an 80% loan, therefore, the maximum house price would be \$17,500. Adjusting this by the Consumer Price Index would result in a current house price of about \$270,000. Using the Census Bureau's change in median house prices since 1940 would suggest a current equivalent of approximately \$1 million—so a HOLC analogy could be imagined to be able to operate today even with California house prices.

The act set the interest rate on the new mortgages to be made by HOLC to refinance the old ones it acquired at not more than 5%. The spread between this mortgage yield and the cost of HOLC bonds over time generated an average spread of about 2.5%. With current long Treasury rates of about 4%, an equivalent spread would imply a lending rate of about 6.5%.

HOLC was a government corporation, whose debt securities were government obligations, like Ginnie Mae today. It had a government board of directors. The Treasury was authorized to invest \$200 million in HOLC stock. How much was \$200 million in 1933? If simply adjusted to current dollars by the Consumer Price Index, it would be the equivalent of about \$3 billion now. If adjusted to be proportional to GDP per capita, \$20 billion. As a proportion of GDP, it would be about \$46 billion.

The act originally authorized HOLC to issue \$2 billion in bonds, or ten times its capital. Using the same three adjustment factors, this would be the equivalent of about \$30 billion, \$200 billion, or \$468 billion today.

During its life, HOLC made more than one million loans to refinance troubled mortgages, something more than half of the loan applications made to it, which represented about 20% of all the mortgages in the country. By 1937, it owned almost 14% of the dollar value of mortgage loans outstanding. This was a remarkable scale of operations. Today, 20% of all mortgages would be about 10 million loans, and 14% of outstanding mortgages would be about \$1.4 trillion—approximately the total of all subprime loans. We would not need this scale of operations, since our mortgage bust, while very serious, does not approach the collapse of the 1930s.

HOLC tried to be as accommodating as possible with its borrowers, and any such organization would have to control the servicing of its loans to carry out its function. As an at-risk lender, there will nonetheless inevitably be re-defaults and credit losses. HOLC ended up itself foreclosing on about 200,000, or 20%, of its loans. Since all these loans started out in default and close to foreclosure, this seems to me a quite respectable performance.

An essential provision of the Home Owners' Loan Act was its unambiguous direction that the directors "shall proceed to liquidate the Corporation when its purposes have been accomplished, and shall pay any surplus or accumulated funds into the Treasury."

In 1951, they did, returning an accumulated surplus of \$14 million. In other words, they about broke even. A goal of a modest profit or breaking even seems appropriate for such an entity.

The principal historian of HOLC, C. Lowell Harriss, attributed much of its successful operations to the leadership of its Chairman, John H. Fahey, further observing that Fahey "consistently worked to liquidate the HOLC rather than to perpetuate or expand its power." Fahey seems to have been a strong personality, who was said to have dismissed 236 lawyers from HOLC for incompetence and to have believed that the ideal business interview was "4 ½ minutes for business and 30 seconds for greetings and farewells." Any new version of the HOLC would doubtless need strong leadership to succeed.

Design Issues

If one wished to create an analogous capability to refinance the mortgage bust, a number of design issues naturally arise.

1. Should a new organization be created or should an existing one be expanded? In this context, the FHA, already slated for expansion, is an obvious possibility. The advantage of using an existing organization is infrastructure already in place; a new organization would have the advantage of clarity of purpose and of its temporary nature, with more ready enforcement of the sunset "when its purposes have been accomplished."
2. Should the government guaranty of its obligations be explicit or implied? HOLC's guaranty was explicit; an implied guaranty seems to involve the creation of a GSE, which I would not recommend.
3. Should the organization fund loans on its own balance sheet, like HOLC, or issue guarantees as a securitization conduit, like Ginnie Mae? Perhaps in today's markets, both.
4. I have been told, though I have not personally studied this issue, that sales of troubled residential mortgages face obstacles because of Privacy Act restrictions on what information servicers may share with potential buyers. Any such obstacles would have to be eliminated for the new refinancing organization to function successfully.
5. As in the 1930s, many troubled mortgages also involve second liens. Without foreclosure, the second liens would have to be addressed in some other fashion. HOLC had to deal with second mortgages and always settled out all subordinate liens as part of its new loan.

6. If a new government corporation were formed, it would need a board of directors. One might consider a board of, say, five government officers, with the Treasury Department playing a leading role, representing the 100% shareholder.

Doubtless we will be able to think of many other issues to be considered.

I am pleased, Mr. Chairman, that you have taken an interest in the possibility of creating such a refinancing capability to help address the ongoing mortgage and foreclosure problems so prominently facing us. On the House side, I have also been working with Congressman Mark Kirk along similar lines. At the very least, we can say that the historical HOLC experience is highly suggestive and well worth studying.

Thank you again for the opportunity to be here today.