

Q&A *with*

Alex J. Pollock

A respected policy analyst and student of the American mortgage market, Alex Pollock examines some of the root causes and possible solutions to the current mortgage market troubles.

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Alex J. Pollock has been a resident fellow at the American Enterprise Institute (AEI) since 2004. He focuses on financial policy issues, including government-sponsored enterprises (GSEs), retirement finance, housing finance, corporate governance and accounting standards, as well as the issues raised by the Sarbanes-Oxley Act. Pollock has frequently testified before congressional committees on a variety of financial policy matters. He was president and chief executive officer of the Federal Home Loan Bank of Chicago from 1991 to 2004. ■ *Mortgage Banking* caught up with Pollock at his Washington, D.C., office late last year just as banks began taking big write-downs on mortgage assets and the House had passed the Mortgage Reform and Anti-Predatory Lending Act of 2007. The following interview covers a range of topics, including the underlying problems that triggered the current credit crunch and some possible solutions.

Q: *What do you see as the systemic risks posed by the mortgage meltdown and the sharp declines in the values of mortgage-backed securities [MBS], collateralized debt obligations [CDOs], structured investment vehicles [SIVs] and related issues?*

A: It is a set of [interlocking] mortgage problems. But underneath that, is a bubble in the price of houses. We had, apparently, the greatest house-price inflation over six or seven years ever experienced in America. And, of course, credit [availability] in general and subprime credit in particular both fed that house-price inflation by making more purchases possible, but it also reflected that house-price inflation because as the price of the house goes up, it looks like you can lend more and more against it.

If you push the price of any asset up high enough, it's going to correct. So now house prices are correcting. . . . According to most knowledgeable people that look at it, we are in a house-price correction, [with] falling house prices on average across the country for maybe a year or two. That hasn't happened—or at least people say that hasn't happened—since the 1930s, that you had [national] average house prices falling. You had a lot of pretty serious regional house-price declines in Southern California, in the Gulf Coast, in Texas, in New England [since the Depression, but no decline on a national-average basis]. So it's a major credit-nourished asset bubble, and now the bubble is deflating and the asset price correcting, and [you see] the consequent pain in credit.

Q: *For example, the secondary market for non-agency securities has collapsed and cut off a lot of mortgage credit.*

A: Yes, absolutely. Of course, that's typical when you get a big bust—then everybody becomes conservative at once. That's really the definition of a bust. All the lenders become conservative at the same time, and then it makes credit for anything in the sector very scarce, and that feeds the falling prices—both on the underlying asset, namely houses, but also all the financial claims, which are ultimately collateralized by houses, like mortgage securities. What happens in a bust is everybody grows conservative and they all want a government guarantee. The cry of a bust is “Give me a government guarantee.”

Q: *How is that playing out in this bust?*

A: [It means that] if things have government guarantees, like Fannie Mae and Freddie Mac for conforming prime mortgages, or like the FHA [Federal Housing Administration], they continue to function. [But other] things, which may be perfectly good credits, people shy away from them because everybody is wild to be protected by the power of the government.

Q: *Are there ways to mitigate temporarily the impact of the bust?*

A: I sort all the efforts [that can be made to deal with] a bust into two main categories. In the first category are

temporary things to do what I call “bridge the bust.” What you're really trying to overcome is this overreaction of the markets. In a moment we'll talk about the overreaction of the politicians. It's human nature to overreact both on the upside and the downside. So, you get an overreaction in the market. The danger is you get a self-reinforcing downward spiral—in a word, deflation. It makes perfect sense to try to do things as long as they are temporary and focused on what I call bridging the bust. You're trying to stay out of the freefall of a self-reinforcing downward spiral. But, as I'm sure you've noticed, the accountants are contributing to the downward spiral. They are so worried about protecting themselves, they are insisting on the most conservative valuations and the biggest write-downs—all of which feed the panic.

Q: *Why are the accountants doing that—is it under any particular rule?*

A: Oh, sure, under the Sarbanes-Oxley era, they are terrified that they'll be blamed.

Q: *They have potential liability?*

A: There are huge liabilities [for accountants]. So, they are going to over-achieve on the conservative side just like everybody else. Think about the role of the accountants.

Q: *Accountants tell me they don't like playing the role of policemen either.*

A: They don't like it, but they can't help it. If you're the accountant, all your incentives are to be as conservative as possible. That is to say, “I won't sign this unless you take a bigger write-down than you think.”

Q: *Well, write-downs are increasing as various indicators of the values of mortgage derivatives keep falling and, to be sure, we don't really know the value of a lot of these assets.*

A: [You're] absolutely right. What's the market value of an asset when there is no market? No one knows. It's probably not par, but it isn't zero, so it's someplace in between. I think the important thing to understand is that you've got this accumulated [attitude that] everybody's playing safe now. So, investors don't want to invest. Lenders only want to lend with big spreads. Accountants want you to write down things to the max. Politicians want to have punitive legislation. And all of that accentuates the downward force.

Q: *What can be done to turn things around?*

A: [There are two categories of things that can be done:] temporary things you can do to try to bridge this downward spiral and the second category of things that are long-term improvements in the way the mortgage market functions. The [failed attempt to set up a] super SIV is one of these temporary “let's bridge the bust” ideas. It didn't work out. The underlying problem was that it was not clear how the risks would be distributed. The other sort of things that you can do—well, you've got the administration's use of the FHA. I think that's a sensible, bridging thing to do.

Q: *The FHASecure program?*

A: Yes, the additional refinancing of subprime loans by the FHA. The next item that I support would be to have Fannie and Freddie have a dedicated portfolio which can [only] be used to refinance subprime loans. I think that's something they can do to really help out.

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Q: *Is anyone on Capitol Hill or in the administration supporting that?*

A: Senator [Chuck] Schumer [D-New York] has a bill introduced to that effect. In his bill, he was going to give them 10 percent additional portfolio [lending authorization], which would be about \$75 billion, but [only] under the condition they use 85 percent of it to refinance subprime loans. My proposal is to give [Fannie and Freddie] each \$100 billion under the condition that they use 100 percent of it for refinancing subprime loans. They've got a portfolio of about \$750 billion, so \$100 billion would be about a 13 [percent] or 14 percent [increase in portfolio lending authorization]. I think Fannie and Freddie can do that. It would be harder to figure out how to manage refinanced subprime loans, but that's a real contribution they can work on. It's a lot harder than taking prime mortgages and issuing government-sponsored debt.

Q: *Do you think it would help to temporarily raise loan limits at Fannie Mae and Freddie Mac?*

A: I am not in favor of that. There is an interesting new program [that is just starting], a [Federal] Home Loan Bank program called Global Mortgage Alliance. [It's being done by] the [Federal] Home Loan Bank of Atlanta. That, I would say, you can definitely [use] as a new outlet for jumbo mortgages, because in that program all of the risk goes into the private sector. It uses the Home Loan Banks as the network for bringing in the loans, but the risk ends up all in private hands. That is being done in partnership with a firm called Hillenbrand Partners in downtown Chicago. I'm an adviser to Hillenbrand Partners, so I have an interest in this.

Q: *Is part of the reason you think Fannie and Freddie should not have higher loan limits that it might impede the revival of the private-label or non-agency mortgage securities market?*

A: Yes. I said before, everybody wants a government guarantee when they're scared. Well, if you offer them a government guarantee, they'll take it. And it will crowd out anything else. For prime jumbos, you don't really need a guarantee on the credit. But, if you offer it, of course, somebody will say, "Why not?"

Q: *The other thing that occurs to me is that if the loan limit is raised, my hunch is it would be difficult to lower it later. Do you think that's true?*

A: I do think that's true. It would be very hard to make that temporary. I think the things you do in these situations that are in the "bridging the bust" mode should be temporary. That would be very hard to keep temporary. It would be like a temporary income tax, in the sense it would be hard to get rid of.

Q: *Are there any emergency solutions to deal with the rising number of defaults headed for foreclosures sales—a trend that threatens a downward spiral in home prices and more defaults?*

A: Yes, one possible temporary solution would be to find an appropriate way to apply the lessons from the success of the Home Owners' Loan Corporation [HOLC], which was created in 1933 to refinance defaulted loans—at a time when roughly half of mortgage debt was in default. It was set up as an emergency and temporary organization that would sunset when it completed its work, and it was shut down in 1951. The HOLC was a government corporation with members of

the Federal Home Loan Bank Board serving as directors. The fundamental idea was for the HOLC to acquire defaulted residential mortgages from lenders and investors, giving its own bonds in exchange. The agency would then refinance the mortgages on more favorable and more sustainable terms. The lender would often take a loss on the principal of the original mortgage, but lenders were willing to trade the mortgages for bonds anyway. The HOLC made more than a million loans to refinance about 20 percent of all the mortgages in the country at the time.

Q: *Are you suggesting a new HOLC today?*

A: No, I am not imagining you would necessarily re-create the same thing, but rather apply the lessons of that successful experience—that is, the best way to address the widespread defaults on mortgages is to refinance the loans into a smaller loan in which the lender takes a loss on the original loan. The FHA could insure the loans and Fannie and Freddie could refinance the loans and pay a discount on the principal to the lenders. Using the HOLC approach, Fannie and Freddie could lend at 6.5 percent and provide a 30-year, fixed-rate mortgage. Any new program [to refinance defaulted mortgages by a new government-backed organization], just like HOLC, should be clearly defined as a temporary program. And any legislation [to set up the new program] should specify that it will sunset after three years.

Q: *What are some of the long-term measures you would suggest to address the problems in the mortgage markets?*

A: On the longer-term side, I have two proposals. One of them is not passing the current [mortgage reform] legislation in the House, which, in my opinion, is justly criticized as being a plaintiff lawyer's benefit act.

Q: *Could you elaborate on that point?*

A: They used to have a saying [about loans], that they're all good when you make [them], but you know some of them are going to be bad. By putting these vague responsibilities [specified in the Mortgage Reform and Anti-Predatory Lending Act of 2007, H.R. 3015] to do only loans which the borrower can afford, you set up a possibility to challenge any loan that goes bad [when someone can easily say] that it must be the lender's fault. I'm sure that the creative plaintiff's bar is salivating so much that it's running down the front of their white shirts at the opportunity this will offer them if this becomes statute.

Q: *Supporters of this provision say that it allows only lawsuits on an individual basis, and that there could not be class-action lawsuits or treble damages, as existed under some Home Ownership and Equity Protection Act [HOEPA] loans—of course, no one makes HOEPA loans. There are limits on the liability imposed on lenders and investors in the Mortgage Reform and Anti-Predatory Lending Act of 2007 [H.R. 3915], and it may not be as bad as one fears.*

"My proposal is to give [Fannie and Freddie] each \$100 billion under the condition that they use 100 percent of it for refinancing subprime loans."

A: My guess is, just like it's hard to make a Fannie Mae increase in loan limits temporary, it's very hard to control what will happen when you create rather vague and subjective rights of borrowers against lenders. If I had to guess how it will evolve, [I would say that it will evolve] in a way which will create a lot of litigation and would certainly reduce the availability of credit. It reminds me of when they passed the Civil Rights Act in the 1960s and Hubert Humphrey [at that time the Democratic senator from Minnesota] said it was absolutely impossible that this act would turn into quotas of any kind. You can't always rely on the best intentions of the legislators. They can't control what is made out of [a piece of enacted legislation] by the people who come after them.

Q: *In this case, what first comes after [enactment] is regulation. And, if [these new rules are] based on the ability of the borrower to pay, it would seem that it would eliminate, almost by definition, alternative-A loans, which are low-documentation and no-documentation loans. If lenders look at all those loans and income-tax returns which may not reflect accurately their ability to repay, then these loans may not be made.*

A: I think that's a fair comment. I'm not sure you can say the loans won't be made—that's a rather absolute statement—but I think you can say it cuts down the availability of such credit. Of course, some people would not like to have any loans like these made. They would say, "Yes, that's my point. I don't want to have any no-doc loans."

Q: *Do you have any more suggestions for long-term solutions?*

A: One idea in terms of long-term solutions is the Pollock one-page disclosure form. I went up to Congress last spring and said that one of the really fundamental problems is that many people don't know what they're doing when they get a mortgage, in terms of the most important things—what does it mean to me [the borrower]. Namely, how much am I going to have to actually pay in order to service this mortgage after it resets or maybe even before it resets, and how does that compare to my income? I said you ought to be able to put the things that really matter to the borrower on one page. Having said it, I then went back to AEI and said, "Well, I guess I ought try it and see if you can really do it." And I did it, to my satisfaction, and it is on the AEI Web site [www.aei.org/scholars/scholarID.88,filter.all/scholar.asp].

I am sure this would be a huge improvement in the mortgage market. It is included in the House [bill, H.R. 3915] . . . Senator Schumer has introduced something very similar, based on testimony I gave to the Joint Economic Committee, when he was chairing it. In the Senate [a one-page form is included in] Senator Schumer's [Mortgage Disclosure Enhancement Act of 2007, S. 2296], and I think there's a good chance we might actually get something done here. And that would be a long-term improvement—that is to say, disclosure that is really designed for the borrower and not disclosure that's really designed to protect the lender.

Tell people in plain language what [their mortgage] does, which we've never done before, to my knowledge, in American mortgage disclosure. It says, "This is your income on which this loan is based, and this is how much of your income it is going to [take to] pay this loan, principal, interest, taxes and

insurance at the beginning—and if it's an adjustable-rate loan, at its fully indexed rate. Now, look at this and make sure you understand it." That is something that can be done. Although it seems so simple, it's never been done before and it would be a huge improvement.

Q: *What long-term solutions would you offer to the problem that originating lenders that do not keep servicing are shielded from the results of their credit decisions for non-agency loans because the risks surrounding the performance of the loans are transferred to investors in the secondary market?*

A: [Indeed, what] I'd like to figure out is how to keep the original lenders—I don't mean the brokers, I mean the lenders—on the hook for the credit [quality] of mortgages that are securitized. People have said many times—and I think it's true in the subprime bust—one of the things that happened is there came to be a great distance between the people making the credit decisions and the people who actually moved the loan. And that obviously contributed to the lowering of standards and the problem. I would like to fix American regulations, primarily bank capital regulations, so that banks and thrifts or, for that matter, a large mortgage bank [such as Countrywide] could do the same thing Fannie and Freddie do—they could themselves guarantee the credit of the pool, of the prime loans they themselves made to their own customers.

So, what I would do is treat other financial institutions exactly the same as Fannie and Freddie in terms of issuing guarantees of mortgage portfolios—45 basis points of capital for prime mortgages. And then you could get the people who are actually making the loans—I'm not talking about the brokers, but the lenders—staying on the hook for the credit, even though they could still access the capital market.

Q: *The 45 basis points would be the charge against the capital?*

A: Yes, it's the capital charge. Fannie and Freddie, when they guarantee an MBS and the MBS is sold into the market, they just have the credit guarantee and their capital charge or capital requirement is 45 basis points. Actually, I think that's quite a rational capital requirement for the pure credit risk on prime mortgages, including private jumbos. You know, we ought to give every other institution [the options that] Fannie and Freddie get, and that, among other things, would create some nice, new competition for Fannie and Freddie.

Q: *Fannie and Freddie will love that.*

A: They will. According to the Pollock plan, they are going to get to refinance the subprime loans and they are going to have a thousand new competitors. **MB**

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