# Financial Services and E-Commerce

## Reflections on the Mortgage Bust and the Inevitable Political Reaction

*By Alex J. Pollock**

We enter 2008 amid the housing and mortgage bust which has, as night the day, followed the housing and mortgage bubble. The deflation of this bubble, and the subsequent credit panic, was the biggest financial news of 2007, and as the deflation of the bubble continues into the new year, it is as much political as financial news. In every housing finance bust, there is an irresistible urge for politicians to "do something" —and they always do. In a financial panic, everybody wants to get a government guarantee, and in one form or another such guarantees are usually provided. Former House Banking Committee Chairman Jim Leach has said that, "The precept of doing nothing should be off the table."[1] The Secretary of the Treasury recently remarked, "Nothing is worse than doing nothing."[2] This is not true in economics, but it is absolutely true in politics.

### The Deflating Bubble

To some astute observers, it was apparent by 2005 that the great American house price inflation of the 21st century, along with the unsustainable expansion of subprime mortgage credit—which both fed the price increases and seemed justified by them—had created a bubble. But bubbles are notoriously hard to control, because so many people are making money from them while they last. As Walter Bagehot so rightly said 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.[3]

By now it is a little hard to remember the former political enthusiasm at rising home ownership rates and the former economic enthusiasm at complex financial innovation. This has been replaced by an international credit market panic; credit contraction with central bank expansion; the closing or bankruptcy of more than a hundred subprime lenders; layoffs; large losses and a deep recession in the homebuilding industry; still accelerating mortgage delinquencies, defaults, and foreclosures; tens of billions of dollars of announced losses by U.S. and foreign financial firms; heavy losses by private mortgage insurance companies; falling house prices and sharply falling house sales; falling state and municipal real estate tax revenue; tightening or disappearing liquidity; increasingly pessimistic forecasts; and, of course, increasing political recriminations.

In mid-2007, typical estimates of the mortgage credit losses involved were about $100 billion. Then they grew to $150 billion, a number cited by Fed Chairman Bernanke (which I believe to be a reasonable estimate of the ultimate credit losses, not including the market value losses from leveraged investments in subprime securities). Other forecasts have the total losses at $250 billion, $300 billion, and even $400 billion. "A hundred billion here, a hundred billion there, and soon we're talking about real money," one is tempted to comment. In financial booms, a competition tends to develop in predicting how high things will go; in the bust, there is a similar competition in predicting how bad they will get. Obviously, uncertainty is high—and a large premium for uncertainty is one reason market prices are depressed.

The most recent bubble and current bust display all the classic patterns of recurring credit over-expansions and their painful aftermaths, as colorfully described by Bagehot, Charles Kindleberger,[4] and Hyman Minsky.[5] Such expansions are always based on the euphoric belief in the ever-rising price of some asset class—in this case, houses and condominiums. This appears to offer a surefire way for buyers, borrowers, lenders, investors, and speculators to make money, and indeed they all do, for a while. As long as the prices always rise, everyone can be a winner. A good example of the bubble spirit was the 2005 book by a housing economist: *Are You Missing the Real Estate Boom? Why the Boom Will Not Bust and Why Property Prices Will Continue to Climb Through the Rest of the Decade*. A similar work from the dot.com stock market bubble, *Dow 40,000*, is currently quoted by Amazon at 32 cents for the hardcover edition.

This time we apparently had the greatest house price inflation in U.S. history. The price inflation stimulated the lenders, the loan brokers, the investors, the bond salesmen, the borrowers, the speculators, the homebuilders, and the flippers. The value of residential real estate about doubled between 1999 and 2006, increasing by $10 trillion. With a total value of about $21 trillion, this is a huge asset class and component of household wealth. The U.S. residential mortgage loan market is the biggest credit market in the world, with outstanding credit grown to over $10 trillion, of which about $1.3 trillion represents subprime mortgages. Securitized U.S. mortgages, prime and subprime, are owned around the world.

### Financial Fragility and the Plank Curve

The unexpected acceleration of subprime mortgage losses and the disruption of the securitized mortgage market created a discontinuous global financial freeze-up. Why was the financial reaction so severe? The short answer is leverage and short-term financing of long-term, risky assets. If the price of an asset is always rising, more leverage always seems better. If the price of an asset is always rising, the credit experience of loans made to finance it will be good, with low delinquencies and defaults, so that the risk of the loans seems less and less, even as the risk is in fact increasing. This process Minsky called the "endogenous build-up of financial fragility." He described the central behavioral elements as follows:

> Acceptable financing techniques… depend upon the subjective preferences and views of bankers…. Success breeds a disregard

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of the possibility of failure; the absence of financial difficulties over a substantial period leads to the development of a euphoric economy in which short-term financing of long positions becomes a normal way of life.[6]

Normal, that is, until the short-term financing is no longer available. When the price of the asset no longer rises, then begins falling, with credit defaults and losses rising instead, overconfidence is replaced by fear. Everybody becomes conservative all at once, and the short-term lenders withdraw—and that creates the panic. The overall pattern was nicely summed up by Velleius Paterculus in his history of Rome (30 AD): "The most common beginning of disaster was a sense of security."

A sense of security in the subprime market was created by models, and securitized subprime mortgages were leveraged in two ways.

First, they were divided into classes or "tranches" of various credit risk, based on the models of investment banks and the credit rating agencies. The resulting junior tranches, sold to yield-hungry investors in both domestic and international markets, were highly leveraged, or sensitive, to the credit losses being worse than the models expected. Junior tranches were then purchased in new collateralized debt obligation ("CDO") vehicles and re-tranched into further senior and junior securities, based on the models, making them even more sensitive to model accuracy, as well as more difficult to understand.

The source is Alan E. Grunewald and Alex J. Pollock, "Money Managers and Bank Liquidity," 1985.

Second, many investors then added to this risk financial leverage, financing subprime mortgage securities with short-term borrowings in the form of repurchase agreements or asset-backed commercial paper. Providers of such short-term credit do not wish to have any meaningful risk and will quickly flee questionable exposures. The resulting structure thus became hyper-leveraged to worse-than-expected outcomes.

As we know now, the reality of subprime credit defaults and losses has turned out far worse than the models predicted, the market value of subprime mortgage-backed securities has dropped far more than expected, and the short-term lenders rapidly withdrew their credit in August 2007. Consider that, for the first half of 2007, the financial world was treated to pontifications about "abundant liquidity" or even "a flood of liquidity," which would guarantee a firm market bid for risky assets and narrow spreads. Suddenly, with bubble turned to bust, there was a "liquidity crisis." At a discussion of the problems of the mortgage bust last fall, a senior economist from a 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 every decade or so is one of the most intriguing things about them. The liquidity dynamic is shown by the graph of the Plank Curve shown here, which represents the amount of short-term credit available in the market as a function of uncertainty and fear. The name of the curve derives from the path of a man walking the plank.

Was it prudent for lenders and leveraged investors to rely so much on models and on bond ratings based on models? Well, what is prudence? In the definition offered by John Maynard Keynes, "A prudent banker is one who goes broke when everybody else goes broke."

### Inevitable Political Reaction

With scores of subprime mortgage lending companies out of business, all remaining lenders, including all the major ones, have cut back drastically on subprime lending or exited altogether and raised mortgage credit standards. Obviously, this reduces the availability of mortgage credit and thereby the demand for houses, just at a time when there is excess supply and high for-sale inventories of new houses, existing houses and condominiums. On top of that, there are record numbers of vacant for-sale houses.

It is evident that an excess supply of houses combined with reduced demand means a trend of falling house prices. The great house price inflation is correcting, and must continue to correct, but how far will prices fall? Informed forecasts suggest perhaps a 15% average drop spread over two years or so. This would suggest about a $3 trillion loss of wealth for American households.

Unfortunately, falling house prices tend to 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, and were made to speculative borrowers, as they were. A key factor in the models used to analyze the risk of mortgages is house price appreciation ("HPA" in the trade lingo). But now the reality is HPD: house price depreciation.

The possibility of a self-reinforcing downward spiral of defaults, declining house prices, losses, credit contraction, and foreclosures—or, in other words, a "debt deflation,"—in so large and important a sector as housing-mortgage finance makes the deflating bubble a hot political issue. Late-cycle political reaction is inevitable. There are two categories of

possible government responses: temporary programs to "bridge the bust"; and fundamental, long-term improvements in the operation of the mortgage market.

To try to ameliorate the probable overshoot of the downward cycle is a reasonable project with much historical precedent. History is clear that governments always intervene in such situations, not always successfully. As the savings and loan crisis gathered force in 1986, for example, the Federal Home Loan Bank Board (FHLBB) published an annual report showing "PUBLIC CONFIDENCE" carved in stone. This turned out to be a tombstone, as the thrifts collapsed and the FHLBB itself was abolished a few years later.

Any "bridging the bust" intervention should be clearly defined as temporary, inhibit as little as possible personal choice and long-run market innovation and efficiency, and should not bail out careless lenders and investors, or speculative borrowers.

Both the Administration and Congress want to use the FHA as a means to create a refinancing capability for subprime mortgages. This is reasonable because the FHA is already a subprime lending institution, and the best way to deal with a troubled subprime loan is to settle it with the proceeds of a new, more affordable refinancing. But with falling house prices, the amount the FHA or anybody could responsibly refinance is liable to be less than the outstanding principal owed on the old subprime mortgage. The owners of these mortgages, typically investors in structured securities issued by a securitization trust, must take a loss for the difference. Investors in speculative instruments should not be bailed out. In economic value the loss has occurred already: it is a matter of the loss being realized. To accept less than full repayment in settlement of a troubled loan from the proceeds of an FHA refinancing, the mortgage servicer, which acts as agent for the investors, would have to be confident that this was a better outcome for the investors than proceeding to foreclosure. Fortunately, from this particular point of view, foreclosure is an extremely expensive process for the investors.

Thus, I believe that a special, temporary program (say for three years) in which the FHA could refinance up to 97% of the current value of the house, even with the existing loan in default, would be a good idea. The investors could accept a loss on any difference between that and the amount owed, which would be an alternative preferable to foreclosure for the investors, as well as obviously so for the borrowers. This would allow the borrowers to go forward with a small positive equity in the property and a loan of more appropriate size.Supposing that the FHA could insure loans in this manner, they would still need to be funded at favorable rates. To help achieve this, I favor granting Fannie Mae and Freddie Mac a special increased portfolio authorization, strictly limited, however, to a segregated portfolio solely devoted to refinancing subprime mortgages. Such a special authorization might be for $100 billion each, easily able to be financed in turn by Fannie and Freddie debt issuance. A very interesting historical analogy to this kind of approach was the Home Owners' Loan Corporation, created by the Home Owners' Loan Act of 1933.[7]

A simple proposal for fundamental improvement of the mortgage market is to make clear to borrowers what the mortgage really means to them with a straightforward one-page form. The subprime mortgage boom obviously overshot on risk creation, but should people be free to take a risk in order to own a home, if they want to? The answer is *Yes*, provided they understand what they are getting into. This is a pretty modest risk, to say the least, compared to those our immigrant and pioneer ancestors took.

And should lenders be able to make risky loans to people with poor credit records, if they want to? *Yes*, provided they tell borrowers the truth about what the loan obligation involves in a straightforward, clear way. A market economy based on voluntary exchange and contracts requires that the parties understand the contracts they are entering into. A good mortgage system requires that the borrowers understand the key facts about how the loan will work and, in particular, how much of their income it will demand. Nothing is more apparent than that the current American mortgage system does not achieve this. Instead it tries to describe 100% of the details in legalese and bureaucratese, which results in approximately zero information transfer to the borrower.

To have informed borrowers who can protect themselves, the key information must be simply stated and clear, in regular-sized type, and presented from the perspective of what commitments the borrower is making and what that means relative to household income. Then the borrowers can "underwrite themselves" for the risk. I have proposed to Congress such a one-page form, "Basic Facts About Your Mortgage Loan," along with brief explanations of the mortgage vocabulary and some avuncular advice for borrowers.[8] This seems to me an idea which should be implemented as a fundamental reform, whatever else is done or not done.

An old banking boss of mine used to say, "Risk is the price you never thought you'd have to pay." This price, including the price of the coming government interventions, will continue to be paid by many parties as the deflation of the housing and mortgage bubble proceeds in 2008.

## Endnotes

1 Quoted in *Is Debate on a Mortgage Fix Near Its Tipping Point?* Am. Banker, Dec. 20, 2007.

2 "Remarks by Secretary Paulson on Actions Taken and Actions Needed in U.S. Mortgage Markets at the Office of Thrift Supervision National Housing Forum," Dec. 3, 2007, *available at* http://www.treas.gov/press/releases/hp706.htm.

3 Walter Bagehot, Lombard Street 78 (1962).

4 *See generally* Charles P. Kindleberger, Manias, Panics, and Crashes (1978). *See also* 5th ed. (rev. Robert Z. Aliber, Palgrave, 2005).

5 *See* Financial Commitments and Instability, ch. 9 *in* Hyman P. Minsky, Stabilizing an Unstable Economy (1986)

6 *Id.* at 213.

7 Alex J. Pollock, *Crisis Intervention in Housing Finance: The Home Owners' Loan Corporation*, AEI Financial Services Outlook, Dec., 2007, *available at* www.aei.org.

8 Alex J. Pollock, *Bank Consolidation, Subprime Mortgage Issues, and the One-Page Mortgage Disclosure: Testimony to the House Committee on Oversight and Government Reform, Subcommittee on Domestic Policy*, May 21, 2007. Testimony and the proposed one-page form available at www.aei.org.