

The Mortgage Problem That Will Confront President Obama

Introduction

Peter J. Wallison

American Enterprise Institute

January 16, 2009

In his letter of resignation from Citigroup's board Robert Rubin wrote: "My great regret is that I and so many of us who have been involved in this industry for so long did not recognize the serious possibility of the extreme circumstances that the financial system faces today."

He isn't the only one. Most analysts failed to foresee the financial crisis, most government policymakers were behind the curve—always trying to catch up to the latest disaster—and now it is clear that even top officials in the financial industry itself failed to grasp the seriousness of what was coming. A dozen or so CEOs are now unemployed because they didn't see the disastrous future and failed to arm their firms with sufficient capital.

Even today, judging from pronouncements coming from analysts and others about recovery starting in the second half of this year, there seems to be little realization of the scope of the problems that lie ahead in housing.

The policymakers are still groping in the dark. The new TARP legislation allocates on \$40 to \$100 billion for mortgage modification. The big debate on the Hill now is over the "cram down" legislation. But is the bankruptcy court system ready for the number of bankruptcies that might come out of 25 million subprime and Alt-A mortgages?

For over a year, as the losses on housing began to come to light, the stock market confined its losses to something between 10 and 15 percent. It was only after the failure of Lehman and the government's call for \$700 billion in TARP funds that the stock market seemed to grasp that something truly unusual was happening, but even now it doesn't seem to have fully taken on board what it means to have the kind of mortgage and housing problem that will be outlined today.

There are probably a lot of explanations for this obtuseness, but it seems to me that one of the key issues is the failure to understand—perhaps a refusal to understand—how large the number and dollar amount of subprime and Alt-A mortgages really are.

Most people who had a vague understanding of the U.S. housing market—and I was certainly one of them—believed that subprime and other non-traditional mortgages were an exception to the general rule. The standard mortgage, they believed, was a 30-year fixed, with a 20 percent down-payment. That, after all, is what homebuyers were offered in the 60s, 70s and 80s. Subprime and Alt-A loans were at most, we believed, a few percent of the total.

As they say: Not! As you will hear in today's conference, the percentage is much larger than a few. It's closer to 40. And in the bubbliest years of the bubble it approached 50 percent of all mortgages originated.

Now these mortgages are failing at unprecedented rates, and we are only at the beginning of the crisis. The banks have set aside reserves for the losses they see in the future, but these reserves do not take account of the reflow effects on the economy generally or of the housing defaults that will be occurring in the future.

Why is it that this information is so slow in coming out?

The answer, I think, is that the reporting of data in the housing field is faulty and was made so by Fannie and Freddie's exemptions from registration with—and hence reporting to—the SEC. In addition, the fact that Fannie and Freddie were seen in the markets as government-backed reduced or eliminated any interest in their risk-taking—so no one was motivated to find out what they were really doing. This is a classic example of moral hazard impairing market discipline.

As a result, neither of these GSEs reported any of their risky loans during the 1990s or through 2007. The fact that they now hold \$1.6 trillion in nonprime mortgages will be a revelation to many people.

Then, even when they started to report to the SEC, they obscured the quality issue by reporting their credit losses in the aggregate, without breaking out their losses on nonprime lending.

Finally, when Fannie and Freddie reported their purchases to mortgage information aggregators such as Loan Performance, they reported all their mortgages as prime. Consequently, anyone who asked Loan Performance—one of the key data sources—for data on subprime loans outstanding did not receive information on about half of the total subprime loans that existed in the housing economy.

Ed Pinto, a former chief credit officer for Fannie Mae—he left in the late 1980s—has done the enormous spadework necessary to uncover the bodies in this area. He has found some startling facts about how serious the mortgage problem actually is. The purpose of this conference is to make sure Ed's remarkable and important work gets out to policymakers and the public. I think you'll find Pinto's data as startling as I did.