Testimony
of
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U.S. House of Representatives
Committee on Financial Services

Subcommittee
on
Capital Markets and Government Sponsored Enterprises
Hearings
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Testimony of William Poole

Mr. Chairman, members of the Committee, I am pleased to be here this morning to comment on the Discussion Draft of a bill to increase standardization, transparency, and to ensure the rule of law in the mortgage-backed security system. My biographical information is in your hands—no need to add to that. For present purposes, the most relevant part of my career is my ten years as President and CEO of the Federal Reserve Bank of St. Louis.

The performance of the mortgage market is critical to the welfare of everyone in this country and to the stability of the financial system. Unfortunately, the Nation is still struggling today with failures, both public and private, in the functioning of the mortgage market. Those failures have left a stain on the economy, ruining many lives and the reducing the assets and security of many citizens. We are all aware—painfully aware—of what has happened and eager to create a better environment in the financial markets of the future.

I will speak in broad-brush terms. Should the Subcommittee or its staff want a more detailed contribution, I would be pleased to work with you.

The Case for Fully Private Mortgage Markets

The United States is the only country with mortgage intermediaries of the form of Fanny Mae and Freddie Mac, two very large government sponsored enterprises. We also have the 12 Federal Home Loan banks and the Federal Housing Administration to address.

Other countries with well-functioning mortgage markets do not have the mortgage intermediaries of the sort we do. There is no evidence of which I am aware that mortgage markets abroad function less well than ours. Indeed, the failure of Fannie Mae and Freddie Mac, at a taxpayer cost of about $150 billion so far, should be a clear warning to us. Moreover, the worldwide financial panic was a direct consequence of the bust in our subprime mortgage market. Quite frankly, any claim that our mortgage market serves us better than the markets abroad sounds pretty fishy to me.

Putting the mortgage market aside, U.S. capital markets are the envy of the world. Our markets are more liquid and more innovative than those elsewhere. We should be very careful not to kill innovation in the financial markets.

It is true that for some years Fannie and Freddie seemed to work well. They grew to an immense size, supported by the implicit federal guarantee of their liabilities. The guarantee meant that the U.S. taxpayer was providing insurance against failure, without charging an insurance premium. The guarantee permitted Fannie and Freddie to pursue portfolio policies that no purely private firm could. They grew and grew and their shareholders and especially senior managements enjoyed handsome returns. I regret that the Occupy Wall Street protesters have not taken aim at Fannie and Freddie, and even more that they were nowhere to be seen when the opportunity to reform these firms was a live issue five and more years ago.

It is absolutely essential to understand the importance of taxpayer subsidy of risk. A period without loss does not mean that there is no subsidy. If the federal government were to provide fire insurance on my house, there would not have been a loss over the years I have been a homeowner. I am careful and have never had a fire. I hope that I never do have a fire. Nevertheless, I do have homeowner's insurance. Everyone understands this point—I could explain to a fourth grader why it makes sense for me to have insurance and why the absence of loss to date does not mean that my purchase of insurance is unwise.

Pricing of insurance is complicated and fire insurance is much more complicated than life insurance. With a widely diversified group of policyholders, life insurance actuaries can project quite accurately loss experience in future years. Losses from fire insurance are much more episodic and the same is true of losses on mortgages. The essence of underwriting fire insurance is that the properties insured be highly diversified, so that a relatively few properties are insured in any one community to avoid conflagration risk.

Mortgage risk is unavoidably subject to conflagration risk, because the business cycle affects so many communities at the same time. Nevertheless, I urge you not accept industry arguments that the federal government must support the market because the presence of correlated business cycle risks means that private firms cannot handle the risk. The private market can handle the risk, as demonstrated by foreign experience and by U.S. experience over business cycles before this most recent one.

Comments on Discussion Draft Bill

In the context of standardizing mortgage products, Fannie Mae and Freddie Mac functioned more like private firms than they did in the accumulation of their portfolios. The issue at hand is whether we need a continuing federal presence in the design of mortgage products.

I am not an expert on many of the technical issues in the discussion draft. However, I confess that l read the draft bill with dismay. I understand, and am in complete sympathy with, the motivation to avoid another catastrophe of the sort we have been living through. Still, the bill reads as an effort to design a complicated product in Washington. Would you ever do the same thing for the design of a computer, or a smart phone, or a web site? I am quite sure not. Even if Washington could create a fine mortgage product today, could the product evolve over time as conditions change? I apologize for using strong language, but it is folly to design a complicated product in Washington and expect the product to remain current and innovative.

I recommend that the committee staff put together, with the assistance of the GSEs, a time line of changes in the major areas of the bill. I suspect that you will find an evolution over time in these provisions, and you should ask whether a federal regulatory framework is likely to be as responsive to changing conditions. I realize that is an argument for delegating many details to the Federal Housing Finance Agency.

However, the extensive delegation of power to the Director of the Federal Housing Finance Agency and the vagueness of the criteria that are supposed to guide his decisions worry me. If this product cannot be designed by this committee and its expert staff, why should it be any easier for the director to design? What this grant of authority to the director would do is to invite a never-ending process of industry pressure and complaint. What the industry does not achieve by direct influence on the director it would seek to achieve through the Congress, getting obscure provisions written into legislation. Why would we want to magnify the decidedly unpretty process under way today as regulators attempt to implement the Dodd-Frank legislation?

The financial crisis was not primarily a consequence of defective design of mortgages. Instead, banks (including investment banks) accumulated too many subprime backed securities while holding too little capital. Banks violated banking principles 101 from 150 years ago by holding risky assets financed with excessively short liabilities and much too little capital.

The problem was not that investors and rating agencies had too little data on the underlying mortgages. They just did not look for the information that was available. Michael Lewis in his very readable and informative book, *The Big Short*, makes clear that the data were there for any portfolio manager who would dig a little. The few who did dig found what they needed.

Standards for securitization should be determined in the market and not by the federal government. Should a hedge fund, for example, want to get into the securitization business, perhaps in some innovative way, should it be blocked by legislation of this sort? Some, I know, would say absolutely yes. I simply disagree. We already have a plethora of rules against fraud, enforceable in the courts through private actions. We must not bog down the private economy with rules and regulations unless we have specific ills that can be addressed that way.

Reform Transition

I have long favored a death sentence for Fannie Mae and Freddie Mac. A pleasing and easy transition into history should not be difficult. Two simple things need to be done. One is to phase down the conforming mortgage limit and the second is to increase securitization fees, perhaps at the rate of 10 percent per year. Both should be legislated and not left to administrative discretion. The legislation might provide that both transitions would begin one year after the bill becomes law. Fannie and Freddie's portfolios should be frozen and the existing mortgages permitted to pay down in the normal course of business. There is no need to sell the existing portfolio—letting it run off will shrink the companies rapidly and they will be mostly gone in seven to ten years.

It is terribly important to put these provisions into statute law and not leave them to administrative discretion. That is the only way to provide reasonable certainty to potential private competitors that it is worth the investment to develop this market. Without that certainty, private competitors will be slow to enter the market and those who want to maintain the GSEs will be able to claim that the private market cannot handle the business.

If you will forgive me for challenging you, I cannot understand those who are defenders of the market in the abstract but are squeamish about starting this transition. I well remember Ronald Reagan's confidence that ending price controls on natural gas would end the shortages in that market, and the conservative doubts about the strategy. Reagan was right, and the evidence appeared in a matter of days.

GSE Reform and the Federal Budget

Fannie and Freddie have cost taxpayers $150 billion so far, and the tab is likely to continue to rise. It appears that the FHA will require taxpayer funds, as will the Pension Benefit Guarantee Corporation. These commitments are on the books and will have to be honored. At this point, all we can do is to avoid making the problems worse and learn from the experience.

For these programs, and dozens of others, I suggest the following criterion. Would you be willing to ask Social Security beneficiaries to accept a 10 percent reduction in benefits to continue housing subsidies? On this day 70 years ago, the United States suffered a terrible loss at Pearl Harbor. Citizens quickly rallied to the defense of the Nation, at great personal cost. Under similar circumstances today, citizens would eagerly volunteer to give up some of their Social Security benefits to pay for national defense.

We would sacrifice the same way for many other existential threats. But would we sacrifice to maintain housing subsidies? The question is almost absurd. I remind you that this country does face an existential threat in the form of insolvency of the United States Government. How can we be defending housing subsidies, and subsidies for windmills and solar panels and for high-speed rail and on and on in the face of this threat? I urge you to ask every advocate of a special interest spending program or tax preference whether he or she believes that the issue is so important that Social Security beneficiaries should be asked to help pay for the program in question.

The answer will always be that we do not have to face that question—that the program or tax break should be financed some other way. So, I repeat the question this way, suppose hypothetically that a cut Social Security benefits were to be considered. Is your program more important? And I remind you of what the answer would have been on this day 70 years ago.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	**2. Organization or organizations you are representing:**
William Poole	Affiliation: University of Delaware but I am not in any way representing the university.
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☐ Yes ☑ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
5) Not to my knowledge, but I have no way of knowing what grants other faculty members may have received.	
7. Signature: William Poole	

Please attach a copy of this form to your written testimony.

RESEND: I did not realize until a few minutes ago that the draft bill was not about reforming/eliminating the GSEs but instead about the design and regulation of mortgage products. In that context, I need to disclose that I served as a private consultant earlier this year to the Mortgage Insurance Companies of America to assess a study as part of a regulatory submission on the issue of defining a qualified residential mortgage. My submission can be found as Appendix 6 in this link: http://www.fdic.gov/regulations/laws/federal/2011/11c190ad74.PDF.

Bill Poole