A Year in Turmoil: An Address By Fed Chairman Ben Bernanke
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An anniversary is an opportunity to reflect on the past and to look ahead. As an economist, I ought to be very cautious about the looking ahead part, as we have had a spotty track record (to say the least) of making predictions. I think the most famous example of an economist making a ridiculous prediction is when Irving Fisher, a few days before the 1929 crash said, "Stock prices have reached what looks like a permanently high plateau."

My own, personal, terrible prediction came in early summer of 2008 as I was preparing to leave Treasury. I told Phill Swagel, the Assistant Secretary of Economic Policy, "You know, I don't think much else will happen between now and the end of the administration." One can now read a substantial number of books about just those seven months that I predicted would be inconsequential.

But in the spirit of ex post rationalizing, in some ways, my statement wasn't entirely ridiculous. By early 2008, we did have a good understanding at Treasury of many of the problems and policy tradeoffs that would later turn out to be the focus of public debates. I will focus on some housing issues – what we knew, what we didn't know, and where we are now.

<u>First, on the issue of foreclosure prevention</u>

- We knew foreclosures would remain high. We were predicting about 2 million foreclosures in 2009. What we didn't know (and still don't) is how the government can best attempt to reduce foreclosures (or mitigate the consequences of foreclosures), while

allowing the necessary housing market adjustments. In 2008, the price-to-rent data, as well as the futures markets, all pointed to a substantial continuing decline in housing prices. There was a large overhang of home inventories that would need to be worked through. The good news is that this adjustment does seem to be finally coming to an end. The inventory of new homes in July was at (a still high) 7.5 months, but down considerably from the 12.4 months of supply in January. The Case-Shiller price index finally showed an increase in prices this past summer. The housing market has now experienced more than a 30 percent decline from its peak, resulting in a price-to-rent ratio back at historical norms.

- We knew that underwater borrowers – the result of price declines coupled with poor underwriting of loans – were the main drivers of the high foreclosure rate. This meant that any modification program directed at making loans affordable would have only modest effects on foreclosures. In 2007, the HOPE NOW program and the American Securitizaton Forum's fast-track program were both private-sector initiatives (albeit with Treasury playing a strong convening role). They were meant to expedite the modification and refinancing process, but by design were not meant to address the problem with foreclosures due to being underwater.

- We knew that the only way to have an even more substantial increase in loan modifications and refinancings was for the government to put some skin in the game. The two plans we considered at the time were 1) a temporary government subsidy (with lender matching) to reduce mortgage interest rates for high-risk borrowers or 2) an aggressive FHA refinancing program, coupled with risk-adjusted guarantee fees paid in part by the government and the lenders.

- The Obama administration has adopted a version of the temporary rate subsidy under its Making Home Affordable program. But the administration's program was not designed to take on the problem of underwater borrowers. As a result, it is making a modest amount of modifications, but cannot stem the elevated numbers of foreclosures.

Treasury's last report said they started 360,000 trial modifications, but it is unclear how many of these will make the required 3-months of payments during the trial period.

- We also knew that the common existence of second liens makes any modification or principal balance reduction program extremely difficult. It hasn't been talked about much, but the Obama administration's modification plan offers 3 cents on the dollar of unpaid balance of second liens.

Now, a little about the GSEs, Fannie and Freddie

- We, along with almost everyone else, knew that the implicit subsidy for the GSEs was a bad idea and we knew that the $5 trillion in GSE liabilities was something to fear. There had been years of advocating for a stronger GSE regulator, but by the summer of 2008 the political impulse was to expand the GSEs' portfolio caps and to lift the conforming loan limits.

- What we didn't know, and we still don't know, is how, when, and to what degree, to separate the public from the private roles of the GSEs. Fannie and Freddie faced legitimate criticisms about being too highly leveraged, about the size and composition of their portfolios, and about their weakened underwriting standards. But at the same time, with the collapse of private securitization in 2007, the government's implicit subsidy of the GSEs meant they were the only game in town supporting the housing market. While government involvement in mortgage finance must be substantially changed, we should not immediately do so while we are working our way out of a housing slump. But as the housing market recovers, and given that the GSEs are in a prolonged "time out" period now that they are under government conservatorship, we should start planning their futures. And we should think carefully about what, if any, role the government should play in providing liquidity to the mortgage market.

- We knew in 2007 that the collapse of subprime would mean greater pressure on FHA to back high-risk loans. I view the continued absence of risk-based pricing for FHA a structural flaw, but I recognize that it is a political feature, allowing FHA to subsidize higher-risk borrowers (at implicit taxpayer expense). It is no surprise that we now see FHA reserves being drained as FHA picks up where subprime originators left off.

- With the GSEs, along with FHA, Ginnie Mae (and indeed many of the Fed programs), I worry that government backing of credit risk is being seen as a free lunch. As I said earlier, now is not the time to eliminate the government's supporting role in the housing market. But government support, either by insuring at a discount against mortgage default through FHA, or by insuring at a discount GSE debt, comes at a price to taxpayers and – under normal conditions – distorts the market toward greater home borrowing and could create the conditions for the next crisis. Ultimately, we need to move policy away from providing incentives to borrow to buy a home. Aside from GSEs and FHA, this also means ending the first-time home buyer tax credit, and changing the mortgage interest deduction and the favorable capital gains tax treatment for housing. None of these changes will be very popular, even at times of full employment, so change will require effective and strong leadership.