



## Mr. Gross Goes to Washington

I've had a lot of high perspiration "Right Guard" moments in my life, although I futilely try to live by Gillette's 1984 advertisement of "never let 'em see you sweat." External composure during times when others around you are losing theirs is a quality that leaders are presumed to require, so I walk like a man and talk like a man, while all the while a little boy inside me is screaming, "Run!" The only time I ever remember totally losing it, though, was when I reached the head of a reception line for Bill and Melinda Gates, nearly 10 years ago. "Nice to meet you, Mike," I said, and my armpits needed a full can and then some for the rest of the evening. Last week was an equally challenging situation as I ventured back to the Treasury in Washington DC which, considering how often we're painted as powerful Washington players, was my very first official visit of any kind in over 35 years at PIMCO. I sort of saw myself as a modern-day Jimmy Stewart – a Bill Gross, instead of a Mr. Smith, going to Washington, but with the same populist spirit; no filibusters or anything, but an idea or two on how to benefit Main as opposed to Wall Street,

in the ongoing housing crisis. And who could possibly object to helping the little guy, I thought? Wrong! Just like Oz isn't Kansas, Washington DC isn't Newport Beach or Des Moines, Iowa. There were lots of powerful people there – special interest groups who said their home was in neighbouring Chevy Chase or Arlington, but that they all worked at a place called "Que" street. Remembering my high school Spanish, I innocently asked if that began with a "Q," and one of the lobbyists gathered around my circle rather dismissively said, "No, it's a single letter and it's between J and L in the Greek alphabet." Shortly thereafter they all drifted off, presumably to find a more informed but less entertaining source of conversation. I guess they must have taken French in high school or maybe I hadn't used enough Right Guard that morning, but at least in my defence, I hadn't called any of them "Mike." My image as a leader presumably was still intact, although my intelligence was in question, a not too uncommon condition in Washington, I might add.

Later that morning, in front of cameras from my favourite television station, C-SPAN, I exercised (exorcised) my leadership role in proposing a solution for the resolution of Fannie Mae (FNMA) and Freddie Mac (FHLMC) and the evolution of housing finance in the United States. I proposed a solution that recognised the necessity, not the desirability, of using government involvement, which would take the form of rolling FNMA, FHLMC, and other housing agencies into one giant agency – call it GNMA or the Government National Mortgage Association for lack of a more perfect acronym – and guaranteeing a majority of existing and future originations. Taxpayers would be protected through tight regulation, adequate down payments, and an insurance fund bolstered by a 50–75 basis point fee attached to each and every mortgage. Seemed commonsensical to me. After all, Fannie and Freddie had really blown up because of the private/public nature of their charter, which incentivised executives and stockholders to go for broke with the implicit understanding that Uncle Sam would be there as a backstop should anything go wrong. If you eliminated the private incentive and provided a tighter regulatory watchdog, we would have no more “liar loans” or “no docs” and a much sounder foundation for future homeowners and investors. The private market, to my mind, had really lost its

claim as the most efficient and judicious arbiter in this particular case. Markets and private incentives without proper guardrails were as threatening to a sound economy in the 21st century as too much regulation and government ownership proved to be in the 1970s.

In addition, my argument had a practical/market-based logic to it. Ninety-five percent of existing mortgage creation over the past 12 months were government guaranteed. The private market was nowhere to be found because they charged too much. **It was the cost of private origination and securitisation, perhaps more than any other factor, that justified government involvement.** Prime, but non-conforming, mortgages (jumbos, insufficient down payments) were being purchased by PIMCO in the hundreds of millions of dollars every week, but at yields of 6, 7, and 8%. If that was the risk/reward tradeoff, compared to FNMA and FHLMC yields at 3.5–4%, how could policymakers pretend that the housing baton could be quickly and cost-effectively passed back to the private market? Few, if any, could afford a new home at those interest rates. If you were a believer in the dominance and superiority of private

markets, how could you deny the signal that markets were sending – that the risk was too high given the substantial losses of recent years?

My argument for the necessity of government backing was substantially based on this commonsensical, psychological, indeed sociological observation that the great housing debacle of 2007–2010+ would have a profound influence on homebuyers and mortgage lenders for decades to come. What did we learn from the Great Depression, for instance: Americans, for at least a generation or more, became savers – dominated by the insecurity of 20%+ unemployment rates and importance of a return of their money as opposed to a return on their money. It should be no different this time, even though the Great R. is a tempered version of the Great D. **Americans now know that housing prices don't always go up, and that they can in fact go down by 30–50% in a few short years. Because of this experience, private mortgage lenders will demand extraordinary down payments, impeccable credit histories, and significantly higher yields than what markets grew used to over the past several decades.** Could an unbiased observer truly believe that housing starts of two million or even one million per year could be generated under the wing of the private market? In front of Treasury

Secretary Geithner and the assembled audience, I said that was impractical. Let me amend that to “ludicrous.”

Policymakers not only have to consider the future “flows” of new mortgage originations, but the existing “stock” of mortgages already created. FNMA and FHLMC either own or have guaranteed \$4.5 trillion of the \$11 trillion mortgage market now on the books. As the Treasury contemplates the “transition” from Agency conservatorship to either public or private hands, how could private market advocates reasonably assume that pension, insurance, bank, and PIMCO-type monies would willingly add nearly \$5 trillion of non-guaranteed, in many cases junk-rated mortgages to their portfolio? They would not. We are in a bind, folks. **Having grown accustomed to a housing market aided and abetted by Uncle Sam, the habit cannot be broken by going cold turkey into the camp of private lending. The cost would be enormous in terms of yields – 300–400 basis points higher than currently offered, crippling any hopes of a housing-led revival to the economy.**

And why do I and PIMCO support this view? Is it some self-interested,

money-making plot to allow us to dominate the bond market? Hardly. Any investor would recognise that it's better to have a 6 or 7% yield instead of 3-4%, so it would be better for PIMCO to let the Administration flood the private market with non-guaranteed, private mortgage product and let us vultures feast on the pickins. No, the self interest rests on "Que" Street. If the housing market continues to be government dominated, then the points from originations and the fees for private insurance would all of a sudden disappear. The vested interest lies on Wall Street, not Newport Beach or Main Street. Try explaining that to commentators intent on returning to a free market ideology that

continues to serve monied interests in the high style to which they are accustomed, but denies a commonsensical, more tightly regulated government alternative for millions of current and future American homeowners. Jimmy Stewart I'm not, and I won't be going back to Washington anytime soon. If I did, though, I'd want to visit those guys on "Que" Street. "K pasa?" I'd say, and then I'd ask if they slept well at night.

William H. Gross  
Managing Director

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