Board of Governors of the Federal Reserve System

Speech

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At the Conference of State Bank Supervisors Annual Conference, Amelia Island Plantation, Florida

Governor Kroszner presented identical remarks to the Banco Central do Brasil Annual Seminar on Banking, Financial Stability, and Risk, on May 27, 2008

May 22, 2008

Prospects for Recovery and Repair of Mortgage Markets

As all of you well know, it was just about one year ago that the turmoil in the mortgage and financial markets emerged. Today I will offer my perspective on the prospects for recovery and repair of the mortgage markets, which I believe will be a gradual process that requires both market and regulatory discipline.

Greater transparency and less complexity in credit instruments will help to promote broader scrutiny of credit risk. Investors with more and better information from the originators and sponsors of credit products will be able to more easily conduct proper due diligence and verify evaluations of credit risk. Financial institutions that develop and hold these instruments and that have similar or correlated exposures through various business lines should also strengthen risk-management practices. As supervisors, we must insist on effective risk management and take the steps necessary to ensure that changes are implemented where needed.

Although any assessment at this stage about the recovery and repair of mortgage markets is preliminary, I will outline some steps, many of which are already in train, that can foster the rehabilitation process. As part of this discussion, I will highlight what the Federal Reserve is doing to facilitate improvements in the mortgage markets, some of which involve important collaborations with the Conference of State Bank Supervisors (CSBS).

Background

As you know, the initial shock to financial markets was essentially a rapid deterioration in the performance of subprime and so-called alt-A mortgages in the United States, particularly among such loans that were originated after the middle of 2005. A large share of those mortgages were funded through structures known as mortgage-backed securities (MBS), and many of those structures were, in turn, funded by other structures called collateralized debt obligations (CDOs), in which subprime and alt-A MBS represented the collateral.

These CDOs were ultimately held by a wide range of investors and financial institutions. Much of the issuance of these securities over the past few years occurred in an environment of tightly compressed risk spreads--that is, the difference between the yields on what were perceived as relatively safe and relatively risky assets was much smaller than usual. Indeed, many of the structures seemed to be created to satisfy investors' strong demand for securities that carried investment-grade ratings but that might provide slightly higher yields than other investment-grade securities, such as corporate bonds. In many cases, however, investors seem to have been attracted to these structured securities without a thorough understanding of the underlying risk profiles.

Although MBS and CDOs had been around for many years, the more recent structures were significantly different and more complex than their earlier counterparts. Investors' earlier experience with CDOs, for example, was mainly limited to cases in which primary securities, such as corporate bonds, business loans, or other simple securities, formed the underlying collateral. In contrast, the more recent CDOs frequently were themselves backed by structured securities, resulting in so-called two-layer securitizations in which structured products are used to fund other structured products.

These two-layer securitizations are inherently more complex and are more exposed to tail risk than their earlier one-layer counterparts. Indeed, in its recent report on credit-risk transfer, the Joint Forum--an international collaboration of financial supervisors--noted a cliff effect that is associated with the distribution of returns that can be realized on the more senior tranches of two-layer securitizations.[1] Simply put, the cliff effect refers to the fact that investors of higher-rated tranches of complex securities can expect to receive a small positive return in most circumstances, but they are vulnerable to extremely large losses in those rare events of widespread financial stress.

Despite the greater complexity, it seems that many investors assumed that the evaluations of credit-rating agencies would work well and be sufficient for the new structured securities. Investors ended up relying too heavily on those assessments rather than requiring ample information about the underlying assets and demanding extra transparency in order to estimate projected risk-return trade-offs.

Role of Information and Transparency in Corporate Bond Market

To illustrate how important information and transparency will be in the recovery and repair process of the securitization markets going forward, it might be helpful to review a case in which, on the whole, market functioning has held up relatively well. I'm thinking specifically about the market for corporate bonds issued by investment-grade nonfinancial firms.

To be sure, over the past year, growing concerns about individual firms' earnings and about the overall macroeconomic outlook have contributed to significantly wider risk spreads on corporate bonds. Nonetheless, investment-grade nonfinancial companies in the United States have been able to issue a sizable volume of traditional debt instruments rather consistently, even as demand for some other types of securities has been substantially curtailed. In addition, on the whole, liquidity in the secondary markets for corporate bonds has been perceived to be much better than liquidity for non-agency mortgage-backed securities and for more-complex structured securities. Part of the reason that the markets for high-grade nonfinancial bonds have continued to function relatively well is that those securities have not experienced widespread ratings downgrades or defaults.

The extensive amount of data available about nonfinancial corporations and the performance of corporate bonds over time has made it easier and less costly for investors to conduct due diligence--or to put it another way--to trust but verify credit-risk evaluations. The same cannot be said of many residential MBS created over the past couple of years and the many complex structured products that held MBS as collateral, where the complexity of the pay-off structures (including so-called cliff effects) made expected returns and risks more difficult to model.

Recovery and Repair Going Forward

As I have said, recovery in the mortgage market will take time and will require more market and regulatory discipline. I would now like to discuss this process in further detail as it relates to the credit-rating agencies, the originate-to-distribute model for mortgage lending, the important role of the new Basel II framework, and improvements in risk-management practices that financial institutions will need to make in several key areas.

Credit-Rating Agencies

As I mentioned, establishing sound and thorough independent risk evaluations is costly, particularly for complex structured products that have only recently been created. To address problems with risk evaluations, the President's Working Group on Financial Markets (PWG) has recommended, among other things, that the credit-rating agencies themselves should display greater skepticism when they are presented with complex and opaque instruments to rate.[2] The PWG also suggested that the credit-rating agencies would better serve investors by providing greater transparency about the models, estimation methods, and assumptions used to evaluate credit risk for complex structured securities. In addition, it is important for the rating agencies to clarify that a given rating applied to a complex structured credit product may have a different risk than the same rating applied to a simple security, such as a corporate bond.

Originate-to-Distribute Approach to Mortgage Lending
The growth of the originate-to-distribute approach in the mortgage market played an important role in the rapid expansion of mortgage lending in the United States until the onset of the recent market turbulence. That expansion was concentrated in the subprime and alt A segments of the mortgage market, where underwriting deteriorated at the point of origination. To an ever-increasing extent from around the middle of 2005 until about a year ago, originators made loans that layered multiple sources of credit risk, including low documentation of borrower income, very high combined loan-to-value ratios, and loans with nontraditional payment schedules that sometimes allowed principal and interest payments to be deferred. In an environment of compressed risk spreads, investors have more difficulty signaling concerns about credit risk, which may have reduced the incentives for originators to maintain strict underwriting.

I would expect the originate-to-distribute model to continue to be an important part of the modern financial market landscape, but, I hope, in a much stronger form. The model works best when the resulting credit instruments are less complex and opaque, as analysts and investors can evaluate the underlying risks with greater certainty. And originate-to-distribute is most effective when the incentives of originators and investors are closely aligned and when market pricing reinforces incentives for originators to perform careful underwriting. Firms surveyed about their risk-management practices by a group of supervisory agencies from France, Germany, Switzerland, the United Kingdom, and the United States--known as the Senior Supervisors Group (SSG)--have emphasized the importance of understanding the quality of new credits that their businesses originate or purchase from others.[3]

The process of recovery and repair in non-agency mortgage securitization markets would also be aided by more clarity and consistency in underwriting standards. This would provide more certainty to the mortgage market, thereby helping to revive investor confidence in this market and to promote the flow of credit to borrowers. Both to protect consumers and to foster the revival of these markets, the Federal Reserve has proposed stricter underwriting rules for high-cost mortgages under the Home Ownership and Equity Protection Act (HOEPA), which could also help to increase the transparency and improve the quality of underlying assets in private mortgage pools.

The Federal Reserve's proposed rules would better protect consumers from a range of unfair or deceptive mortgage lending and advertising practices. Our proposal includes four key protections for higher-priced mortgage loans secured by a consumer's principal dwelling: (1) creditors would be prohibited from engaging in a pattern or practice of extending credit without considering borrowers' ability to repay the loan; (2) creditors would be required to verify the income and assets they rely upon in making a loan; (3) prepayment penalties would only be permitted if certain conditions are met, including the condition that no penalty will apply for at least sixty days before any possible payment increase; and (4) creditors would have to establish escrow accounts for taxes and insurance. We are working toward issuing final regulations in July.

Role of Basel II
Individual institutions are responsible for maintaining sound risk-management practices. But supervisors, of course, also have a role to play in both promoting effective risk management and offering incentives for bankers to make improvements to their practices.

The new Basel II framework is a substantial supervisory initiative that seeks to improve risk-management practices at banking organizations. The framework more closely aligns regulatory capital requirements with actual risks, which should lead institutions to make better decisions about extending credit, mitigating risks, and determining overall capital needs. For example, unlike under Basel I, the risk weights applied to first-lien residential mortgages will be subject to a more refined differentiation depending on whether the borrower has low or high credit risk. Similarly, Basel II attempts to more fully capture risks in securitization transactions.

Just as lessons learned from recent events can help bankers improve risk- management practices, they can also help supervisors further increase the effectiveness of the Basel II framework. For example, the Basel Committee on Banking Supervision plans to strengthen the resiliency of Basel II by revising it to establish higher capital requirements for certain complex structured credit products, such as CDOs of asset-backed securities, among other enhancements.[4]

Improvements in Risk-Management Practices
Studies of last year's events have concluded that part of the reason that the problems with subprime and alt-A mortgages led to much wider financial market turmoil was weaknesses in the risk-management practices at some large global financial firms that created and held complex credit products. Recent events have highlighted the need for risk-management improvements in four fundamental areas: risk identification and measurement, liquidity risk management, governance and risk control, and valuation practices.

First, for risk identification and measurement, as all of you here know, good information is the lifeblood of sound risk management. A good risk-management structure is designed to identify the full spectrum of risks across the entire firm, gathering and processing information on an enterprise-wide basis in real time. In short, you cannot manage your risks if you do not know what they are.

Recent events have illustrated that many large, complex institutions had exposures to subprime mortgages that ran across independent business lines, through off-balance-sheet conduits such as structured investment vehicles, and with respect to numerous counterparties such as monoline financial guarantors. But too few institutions fully recognized their aggregate exposure to risks that turned out to be highly correlated. Latent risks from certain complex products and certain risky activities are particularly problematic because they can manifest themselves when market turbulence sets in. Stress testing and scenario analysis are essential because they can reveal potential risk concentrations that may not be apparent when using information gleaned from normal times.

The second fundamental area is liquidity risk management. Because of its central role in the business of banking, liquidity risk requires rigorous and effective management. Recent events have shown that during times of systemwide stress, liquidity shocks can become correlated, so that the same factors that can lead to liquidity problems for the bank's assets or off-balance-sheet vehicles can simultaneously put pressure on a bank's own funding liquidity. Because risk concentrations have the potential to manifest themselves during times of stress and at that time adversely affect capital positions, it is particularly important that firms assess how liquidity events could place pressure on capital levels.

The third fundamental, governance and risk control, has been a key factor that has differentiated performance across financial institutions during the recent turmoil. Firms that operated with the two main ingredients for solid governance and controls--thorough information and strong incentives--have come through this tumultuous period in better condition.

Lastly, supervisors' comparative reviews also identified valuation practices as critical. The SSG reported that those firms that paid close attention to the problems associated with the valuation of financial instruments, particularly those for which markets were not deep, fared better. These more-successful firms developed in-house expertise to conduct independent valuations and refrained from relying solely on third-party assessments.

Federal Reserve's Mortgage Initiatives
I would now like to discuss some of the actions the Federal Reserve is taking to address the ongoing challenges in the mortgage market. The Federal Reserve's decisions regarding monetary policy and our efforts to promote financial stability affect mortgage and housing markets, of course. But, we are also working on these issues more directly on a number of fronts as we are very concerned about the high rate of mortgage foreclosures.

We are contributing to initiatives already under way at the local and national level, as well as collaborating with other regulators, community groups, policy organizations, financial institutions, and public officials in an effort to identify ways to prevent unnecessary foreclosures and the associated negative effects on local communities. In doing so, we are taking advantage of the decentralized geographic structure of the Federal Reserve System, which consists of the Board of Governors in Washington, D.C., and the twelve Federal Reserve Banks that each represent a region of the country.

In recent months, for example, I have had the opportunity to get a firsthand look at what is happening in various parts of the country. I have met with local community groups, bankers, housing advocates, counseling agencies, and state and local government officials in Cincinnati, Minneapolis, Philadelphia, Boston, Miami, and Las Vegas. The Reserve Banks representing those areas have helped facilitate these meetings, which have enhanced my understanding of the challenges being faced across the country and of how policymakers should think about these issues at both the local and national levels.

We are engaged with mortgage servicers to understand impediments they may face when modifying loans or offering other alternatives to foreclosure. We have encouraged the mortgage industry to increase their efforts to work with troubled borrowers, to develop guidelines and templates for reasonable standardized approaches to various loss-mitigation techniques, and to adopt transparent reporting standards. Clear disclosures of loan modifications will not only make it easier for regulators, the mortgage industry, and community groups to assess the effectiveness of foreclosure-prevention efforts, but they will also foster greater transparency, and hence greater confidence, in the securitization market.

We are also using our analytic resources to conduct research that the Reserve Banks can disseminate to local community groups, counseling agencies, financial institutions, and others who are working to help troubled borrowers and communities. Earlier this month, we announced a new partnership with the nonprofit NeighborWorks America to develop materials, tools, and training programs to help communities and others acquire and manage vacant properties. The goal is to support the provision of affordable rental housing and new homeownership opportunities in low- and moderate-income neighborhoods.

The Federal Reserve has collaborated with the CSBS on several interagency initiatives to help struggling homeowners and to enhance the functioning of the mortgage markets. The federal banking agencies and the CSBS last fall issued guidance urging lenders and servicers to pursue workout arrangements, when feasible and prudent, as an alternative to foreclosure. Reaching borrowers before they fall too far behind in their payments is important to effecting a sustainable workout and may help more borrowers remain in their homes. In some cases, temporary adjustments to payments may not be sufficient, and more-permanent reductions in interest rates or an extension of the loan term may be called for. In some situations, lenders and servicers may want to consider using principal writedowns as a way to reduce re-default risk or to facilitate a refinancing.

We are also coordinating with the CSBS, the American Association of Residential Mortgage Regulators (AARMR), and other federal agencies on consumer compliance reviews of non-depository mortgage lenders with significant subprime mortgage operations. These reviews, which began earlier this year, are aimed at evaluating underwriting standards, risk-management strategies, and compliance with certain consumer protection laws.

The Federal Reserve is also working cooperatively with the states to provide data and analysis on subprime mortgage loan performance to inform the states' policies in this area. These efforts will be supported by the new system for registering and tracking mortgage brokers that the CSBS and the AARMR launched earlier this year. The Nationwide Mortgage Licensing System should better protect borrowers by bringing greater consistency across the states to the supervision of mortgage lenders. Nationwide licensing should prevent lenders who run afoul of authorities in one state from simply relocating their business to another state.

Conclusion
As market participants take steps to foster greater transparency and to reduce the complexity of

structured credit instruments, I believe that recovery and repair in the mortgage markets will take hold over time. Moreover, as financial institutions strengthen risk-management practices and as supervisors ensure that the necessary actions are taken, I expect the financial system as a whole to become more resilient. A number of efforts are under way by the Federal Reserve, jointly and independently with the CSBS and other organizations, to help prevent avoidable foreclosures and to promote responsible mortgage lending.

Footnotes

1. The Joint Forum (2008), *Credit Risk Transfer--Developments from 2005 to 2007* (Basel, Switzerland: Bank for International Settlements). Return to text

2. President's Working Group on Financial Markets (2008), "Policy Statement on Financial Market Developments (1.36 MB PDF)" (Washington: Department of the Treasury). Return to text

3. The report, "Observations on Risk Management Practices during the Recent Market Turbulence," is available at:
http://www.newyorkfed.org/newsevents/news/banking/2008/rp080306.html Return to text

4. For further discussion of plans to strengthen the resiliency of the framework, refer to Randall S. Kroszner (2008), "Risk Management and Basel II," speech delivered at the Federal Reserve Bank of Boston AMA Conference, May 14. Return to text

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