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Reducing Preventable Mortgage Foreclosures

Remarks by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

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Over the past year and a half, mortgage delinquencies have increased sharply, especially among riskier loans. This development has triggered a substantial and broad-based reassessment of risk in financial markets, and it has exacerbated the contraction in the housing sector. In my remarks today, I will discuss the causes of the distress in the mortgage sector and then turn to the key question of what can be done in this environment to reduce preventable foreclosures.

Although I am aware, as you are, that community banks originated few subprime mortgages, community bankers are keenly interested in these issues; foreclosures not only create personal and financial distress for individual homeowners but also can significantly hurt neighborhoods where foreclosures cluster. Efforts by both government and private-sector entities to reduce unnecessary foreclosures are helping, but more can, and should, be done. Community bankers are well positioned to contribute to these efforts, given the strong relationships you have built with your customers and your communities.

The Rise in Mortgage Delinquencies and Foreclosures

Mortgage delinquencies began to rise in mid-2005 after several years at remarkably low levels. The worst payment problems have been among subprime adjustable-rate mortgages (subprime ARMs); more than one-fifth of the 3.6 million loans outstanding were seriously delinquent at the end of 2007.[1] Delinquency rates have also risen for other types of mortgages, reaching 8 percent for subprime fixed-rate loans and 6 percent on adjustable-rate loans securitized in alt-A pools. Lenders were on pace to have initiated roughly 1-1/2 million foreclosure proceedings last year, up from an average of

[1] Based on servicer data from First American LoanPerformance. Serious delinquencies include loans ninety days or more past due or in foreclosure.

fewer than 1 million foreclosure starts in the preceding two years.[2] More than one-half of the foreclosure starts in 2007 were on subprime mortgages.

The recent surge in delinquencies in subprime ARMs is closely linked to the fact that many of these borrowers have little or no equity in their homes. For example, data collected under the Home Mortgage Disclosure Act suggest that nearly 40 percent of higher-priced home-purchase loans in 2006 involved a second mortgage (or "piggyback") loan. Other data show that more than 40 percent of the subprime loans in the 2006 vintage had combined loan-to-value ratios in excess of 90 percent, a considerably higher share than earlier in the decade.[3] Often, in recent mortgage vintages, small down payments were combined with other risk factors, such as a lack of documentation of sufficient income to make the required loan payments.

This weak underwriting might not have produced widespread payment problems had house prices continued to rise at the rapid pace seen earlier in the decade. Rising prices provided leveraged borrowers with significant increases in home equity and, consequently, with greater financial flexibility. Instead, as you know, house prices are now falling in many parts of the country. The resulting decline in equity reduces both the ability and the financial incentive of stressed borrowers to remain in their homes. Indeed, historically, borrowers with little or no equity have been substantially more likely than others to fall behind in their payments. The large number of outstanding mortgages with negative amortization features may exacerbate this problem.

Delinquencies and foreclosures likely will continue to rise for a while longer, for several reasons. First, supply-demand imbalances in many housing markets suggest that

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[2] Historically, more than half of foreclosure starts resulted in sale of the property.
[3] Based on information about loans in securitized pools from First American LoanPerformance.

some further declines in house prices are likely, implying additional reductions in borrowers' equity. Second, many subprime borrowers are facing imminent resets of the interest rates on their mortgages. In 2008, about 1-1/2 million loans, representing more than 40 percent of the outstanding stock of subprime ARMs, are scheduled to reset. We estimate that the interest rate on a typical subprime ARM scheduled to reset in the current quarter will increase from just above 8 percent to about 9-1/4 percent, raising the monthly payment by more than 10 percent, to $1,500 on average. Declines in short-term interest rates and initiatives involving rate freezes will reduce the impact somewhat, but interest rate resets will nevertheless impose stress on many households.

In the past, subprime borrowers were often able to avoid resets by refinancing, but currently that avenue is largely closed. Borrowers are hampered not only by their lack of equity but also by the tighter credit conditions in mortgage markets. New securitizations of nonprime mortgages have virtually halted, and commercial banks have tightened their standards, especially for riskier mortgages. Indeed, the available evidence suggests that private lenders are originating few nonprime loans at any terms.

This situation calls for a vigorous response. Measures to reduce preventable foreclosures could help not only stressed borrowers but also their communities and, indeed, the broader economy. At the level of the individual community, increases in foreclosed-upon and vacant properties tend to reduce house prices in the local area, affecting other homeowners and municipal tax bases. At the national level, the rise in expected foreclosures could add significantly to the inventory of vacant unsold homes--

already at more than 2 million units at the end of 2007--putting further pressure on house prices and housing construction.[4]

Helping Distressed Borrowers

Policymakers and stakeholders have been working to find effective responses to the increases in delinquencies and foreclosures. Steps that have been taken include initiating programs designed to expand refinancing opportunities and efforts to facilitate and increase the pace of loan workouts. Troubled borrowers will always require individual attention, and the most immediate impacts of foreclosures are on local communities. Thus, the support of counselors, lenders, and organizations with local ties is critical.

Of course, care must be taken in designing solutions. Measures that lead to a sustainable outcome are to be preferred to temporary palliatives, which may only put off foreclosure and perhaps increase its ultimate costs. Solutions should also be prudent and consistent with the safety and soundness of the lender. Concerns about fairness and the need to minimize moral hazard add to the complexity of the issue; we want to help borrowers in trouble, but we do not want borrowers who have avoided problems through responsible financial management to feel that they are being unfairly penalized.

Let me turn now to some recent efforts to help distressed borrowers refinance. The FHASecure plan, which the Federal Housing Administration (FHA) announced late last summer, offers qualified borrowers who are delinquent because of an interest rate reset the opportunity to refinance into an FHA-insured mortgage. Recently, the Congress

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[4] As already noted, foreclosure starts likely increased by roughly 50 percent to 1-1/2 million last year, and foreclosure starts are on track to rise further this year. Lender reports suggest that well over half of these foreclosure starts could result in property sales.

and Administration temporarily increased the maximum loan value eligible for FHA insurance, which should allow more borrowers, particularly those in communities with higher-priced homes, to qualify for this program and to be eligible for refinancing into FHA-insured loans more generally. These efforts represent a step in the right direction. Not all borrowers are eligible for this program, of course; in particular, some equity is needed to qualify. In addition, second-lien holders must settle or be willing to re-subordinate their claims for an FHA loan, which has sometimes proved difficult to negotiate. Separately, some states have created funds to offer refinancing options, but eligibility criteria tend to be tight and the take-up rates appear to be low thus far.

In cases where refinancing is not possible, the next-best solution may often be some type of loss-mitigation arrangement between the lender and the distressed borrower. Indeed, the Federal Reserve and other regulators have issued guidance urging lenders and servicers to pursue such arrangements as an alternative to foreclosure when feasible and prudent.[5] For the lender or servicer, working out a loan makes economic sense if the net present value (NPV) of the payments under a loss-mitigation strategy exceeds the NPV of payments that would be received in foreclosure.[6] Loss mitigation is made more attractive by the fact that foreclosure costs are often substantial. Historically, the foreclosure process has usually taken from a few months up to a year and a half, depending on state law and whether the borrower files for bankruptcy. The losses to the lender include the missed mortgage payments during that period, taxes, legal and administrative fees, real

[5] Board of Governors of the Federal Reserve System (2007), "Working with Mortgage Borrowers," Division of Banking Supervision and Regulation, Supervision and Regulation Letter SR 07-6 (April 17); and "Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages," Supervision and Regulation Letter SR 07-16 (September 5).

[6] By comparing these NPVs, servicers can fulfill their obligation to investors under many pooling and servicing agreements, which is to maximize the return from all loans in the trust, including those that are in default or are reasonably likely to default.

estate owned (REO) sales commissions, and maintenance expenses. Additional losses arise from the reduction in value associated with repossessed properties, particularly if they are unoccupied for some period.

A recent estimate based on subprime mortgages foreclosed in the fourth quarter of 2007 indicated that total losses exceeded 50 percent of the principal balance, with legal, sales, and maintenance expenses alone amounting to more than 10 percent of principal. With the time period between the last mortgage payment and REO liquidation lengthening in recent months, this loss rate will likely grow even larger. Moreover, as the time to liquidation increases, the uncertainty about the losses increases as well. The low prices offered for subprime-related securities in secondary markets support the impression that the potential for recovery through foreclosure is limited. The magnitude of, and uncertainty about, expected losses in a foreclosure suggest considerable scope for negotiating a mutually beneficial outcome if the borrower wants to stay in the home.

Unfortunately, even though workouts may often be the best economic alternative, mortgage securitization and the constraints faced by servicers may make such workouts less likely. For example, trusts vary in the type and scope of modifications that are explicitly permitted, and these differences raise operational compliance costs and litigation risks. Thus, servicers may not pursue workout options that are in the collective interests of investors and borrowers. Some progress has been made (for example, through clarification of accounting rules) in reducing the disincentive for servicers to undertake economically sensible workouts. However, the barriers to, and disincentives for, workouts by servicers remain serious problems that need to be part of current discussions about how to reduce preventable foreclosures.

We now have more information about the recent pace of loss-mitigation activity than we did just a few months ago, thanks to surveys of servicers by the Mortgage Bankers Association, the Conference of State Bank Supervisors, the Hope Now Alliance, and others. These surveys generally indicate that servicers substantially increased the number of loan workouts in the latter part of last year. The Hope Now Alliance estimates that workouts of subprime mortgages rose from around 250,000 in the third quarter of 2007 to 300,000 in the fourth quarter, while workouts of prime mortgages rose from 150,000 to 175,000 over the same period. The pace of workouts picked up a bit more in January.

Despite this progress, delinquency and default rates have risen quickly, and servicers report that they are struggling to keep up with the increased volumes. Of course, not all delinquent subprime loans can be successfully worked out; for example, borrowers who purchased homes as speculative investments may not be interested in retaining the home, and some borrowers may not be able to sustain even a reduced stream of payments. Nevertheless, scope remains to prevent unnecessary foreclosures.

Lenders and servicers historically have relied on repayment plans as their preferred loss-mitigation technique. Under these plans, borrowers typically repay the mortgage arrears over a few months in addition to making their regularly scheduled mortgage payments. These plans are most appropriate if the borrower has suffered a potentially reversible setback, such as a job loss or illness. However, anecdotal evidence suggests that even in the best-case scenarios, borrowers given repayment plans re-default at a high rate, especially when the arrears are large.

Loan modifications, which involve any permanent change to the terms of the mortgage contract, may be preferred when the borrower cannot cope with the higher payments associated with a repayment plan. In such cases, the monthly payment is reduced through a lower interest rate, an extension of the maturity of the loan, or a write-down of the principal balance. The proposal by the Hope Now Alliance to freeze interest rates at the introductory rate for five years is an example of a modification, in this case applied to a class of eligible borrowers.

To date, permanent modifications that have occurred have typically involved a reduction in the interest rate, while reductions of principal balance have been quite rare. The preference by servicers for interest rate reductions could reflect familiarity with that technique, based on past episodes when most borrowers' problems could be solved that way. But the current housing difficulties differ from those in the past, largely because of the pervasiveness of negative equity positions. With low or negative equity, as I have mentioned, a stressed borrower has less ability (because there is no home equity to tap) and less financial incentive to try to remain in the home. In this environment, principal reductions that restore some equity for the homeowner may be a relatively more effective means of avoiding delinquency and foreclosure.

Lenders tell us that they are reluctant to write down principal. They say that if they were to write down the principal and house prices were to fall further, they could feel pressured to write down principal again. Moreover, were house prices instead to rise subsequently, the lender would not share in the gains. In an environment of falling house prices, however, whether a reduction in the interest rate is preferable to a principal writedown is not immediately clear. Both types of modification involve a concession of payments, are susceptible to additional pressures to write down again, and result in the same payments to the lender if the mortgage pays to maturity. The fact that most mortgages terminate before maturity either by prepayment or default may favor an interest rate reduction. However, as I have noted, when the mortgage is "under water," a reduction in principal may increase the expected payoff by reducing the risk of default and foreclosure.

In my view, we could also reduce preventable foreclosures if investors acting in their own self interests were to permit servicers to write down the mortgage liabilities of borrowers by accepting a short payoff in appropriate circumstances. For example, servicers could accept a principal writedown by an amount at least sufficient to allow the borrower to refinance into a new loan from another source. A writedown that is sufficient to make borrowers eligible for a new loan would remove the downside risk to investors of additional writedowns or a re-default. This arrangement might include a feature that allows the original investors to share in any future appreciation, as recently suggested, for example, by the Office of Thrift Supervision. Servicers could also benefit from greater use of short payoffs, as this approach would simplify the calculation of expected losses and eliminate the future costs and risks of retaining the troubled mortgage in the pool.

A potentially important step to facilitate greater use of short payoffs is the modernization of the FHA, which I have supported. Going beyond the current proposals for modernization, permitting the FHA greater latitude to set underwriting standards and risk-based premiums for mortgage refinancing--in a way that does not increase the expected cost to the taxpayer--would allow the FHA to help more troubled borrowers. A concern about such an approach is that servicers might refinance only their riskiest borrowers into the FHA program. A combination of careful underwriting, the use of risk premiums, and other measures (for example, a provision that would allow the FHA to return a mortgage that quickly re-defaults to the servicer) could help mitigate that risk.

There are, no doubt, tax-related, accounting, and legal obstacles to expanding the use of principal writedowns. For example, investors in different tranches of mortgage-backed securities may not benefit equally, securitized trusts may not be permitted to acquire new equity warrants, and principal writedowns may require a different accounting treatment than interest rate reductions. But just as market participants, with the help of regulators, obtained greater clarity on the use of interest rate freezes through guidelines issued by the American Securitization Forum, industry and regulator efforts could also help clarify how this alternative type of workout might be effectively applied.

Federal Reserve System Efforts

I would like to comment briefly on Federal Reserve System efforts to reduce preventable foreclosures and their costs on borrowers and communities. The Federal Reserve can help by leveraging three important strengths: our analytical and data resources; our national presence; and our history of working closely with lenders, community groups, and other local stakeholders. A major thrust of our efforts is sharing relevant and timely data analysis of mortgage delinquencies with community groups and policymakers to efficiently target resources to areas most in need. For example, we recently assisted NeighborWorks America in identifying regions and neighborhoods that are at risk of higher rates of foreclosure and could benefit from increased mortgage counseling capacity. On the basis of this analysis, NeighborWorks recently distributed

$130 million in newly granted funds from Congress to thirty-two state housing finance agencies, eighty-two community-based NeighborWorks organizations, and sixteen counseling intermediaries around the country.

The Federal Reserve System also is supporting efforts to reach troubled borrowers and to raise awareness in communities about ways to prevent foreclosures. Since July, the community affairs groups across the Federal Reserve System have sponsored or cosponsored more than fifty events related to foreclosures, reaching more than 4,000 attendees including lenders, counselors, community development specialists, and policymakers.

We are also concerned about the challenges of neighborhoods that have seen large increases in foreclosures and vacant properties and have begun to work with policymakers, lenders (including community banks) and community groups to address these problems. In particular, we have undertaken a joint effort with NeighborWorks America to help communities develop strategies for neighborhood stabilization.

Conclusion

Reducing the rate of preventable foreclosures would promote economic stability for households, neighborhoods, and the nation as a whole. Although lenders and servicers have scaled up their efforts and adopted a wider variety of loss-mitigation techniques, more can, and should, be done. The fact that many troubled borrowers have little or no equity suggests that greater use of principal writedowns or short payoffs, perhaps with shared appreciation features, would be in the best interest of both borrowers and lenders. This approach would be facilitated by allowing the FHA the flexibility to offer refinancing products to more borrowers.

Ultimately, though, real relief for the mortgage market requires stabilization, and then recovery, in the nation's housing sector. Modernization of the FHA would be of help on this front as well. I am sure that the FHA and the Department of Housing and Urban Development, given the appropriate powers by the Congress, will make every effort to expand their operations and to help improve the functioning of the market for home-purchase mortgages. For community bankers, FHA modernization and expansion would provide an important opportunity--of which I urge you to take advantage--to better serve your customers and community.

The government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, likewise could do a great deal to address the current problems in housing and the mortgage market. New capital-raising by the GSEs, together with congressional action to strengthen the supervision of these companies, would allow Fannie and Freddie to expand significantly the number of new mortgages that they securitize. With few alternative mortgage channels available today, such action would be highly beneficial to the economy. I urge the Congress and the GSEs to take the steps necessary to allow more potential homebuyers access to mortgage credit at reasonable terms.