Remarks by
Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation
On
The Future of Mortgage Finance
at the
2008 Annual Meeting National Association
For
Business Economics
Washington, D.C
October 6, 2008

I'm most honored to be here today. Thanks for inviting me to speak at your 50th annual meeting. For 50 years, the N-A-B-E has worked to make the discipline of economics more accessible and more useful to its members. And your advocacy over the last decade for better data collection and more accurate economic statistics, is improving the analysis that business planners and economic policymakers depend on.

For that, I congratulate NABE on your golden anniversary. And thanks for 50 years of helping make it easier for us to make better decisions. This is also a landmark year for the FDIC. It's our 75th anniversary.

Deposit insurance was a new concept back when President Roosevelt signed the legislation creating the FDIC. The FDIC was created in a time of crisis to restore public confidence and stability in the banking system after many bank failures during the Great Depression. The concept has worked extremely well ever since. It's been called the glue that holds our banking system together. A hundred nations now have some form of deposit insurance, but we were the first. And I dare say more nations will likely join the club.

And my hat goes off to Main Street America for being so confident in FDIC insured institutions over the years. Most people know that our promise of protection for their insured deposits is a commitment that will never go away.

The Present Crisis

Today the nation faces a new period of great financial stress that is again prompting government to step in to help restore order to financial markets and the banking system. The so-called "great moderation" in the performance of our economy has given way to severe credit market distress that is now taking a toll on the "real economy", on the general public, on Main Streets across the country.

This as we know has led to major government efforts to minimize the impact on large financial institutions and consumers. Let me address two critical and timely issues this afternoon. First is the FDIC's current role in resolving the credit crisis. And second: how

I believe we need to change mortgage finance by tightening consumer-protection rules and restoring back-to-basics lending practices.

FDIC role

At the FDIC, we're focused on our core mission ... supervising banks ... quickly resolving failed banks or those in trouble ... and insuring bank deposits. Above all else, the deposit insurance guarantee is absolute. Our deposit insurance fund is some 45 billion dollars strong. The immediate backstop is the equity capital of the banking industry itself, which stands at over 1.3 trillion dollars. And ultimately, the fund is backed by the full faith and credit of the United States government.

Last week, as part of the financial markets bill, Congress voted to temporarily increase the deposit insurance cap from $100,000 to $250,000. This increase does not solve all of the problems in the industry. But it will give a greater degree of assurance to depositors at a time when public confidence in the safety of their money is critically important. We're working aggressively to implement these changes made by the new law.

Tomorrow the FDIC Board will consider an increase in our insurance premiums to bolster the fund. The fund has decreased as a result of recent bank failures. We'll also be proposing changes to the current system that will shift a greater share of any increase onto riskier institutions. It seems only fair that we reward behavior that reduces our costs. And higher risk institutions can reduce their premiums by changing their risk profiles.

We're working hard to assure that our industry-funded reserves will be sufficient to cover projected losses from more bank failures. At the same time ... given this period of uncertainty ... it's important for people to understand that we have ample authority to borrow from the Treasury Department if need be.

The public should also know that if we do borrow, those funds will be repaid through industry assessments, and at no cost to the taxpayer. Despite the protracted turmoil in the credit markets, I'm proud that we have not asked for help from the U.S. Treasury. Secretary Paulson already has enough people knocking on his door!

A short history of mortgage finance

But even as we manage the current situation, we need to look at what we've learned about our system of mortgage finance. We need to decide whether it can be made once again to work for all Americans. And from that, we can develop guiding principles for reforming the system and more significantly, for restoring the hope of homeownership as a way to build wealth.

It wasn't so long ago that our mortgage finance system was envied and seen as a model for the rest of the world. The credit market infrastructure that was built around

homeownership after the Second World War was the foundation for a remarkable period of economic growth.

Over the past 60 years, the 30-year, plain vanilla fixed-rate mortgage gave stability to our families and our communities. At one time, it was hailed as an innovation in its own right ... a vast improvement over the short-term, callable mortgages that were common before the 1930s.

As you are aware, much of the turmoil in credit markets and housing is related to more recent mortgage innovations that took us away from the traditional 30-year model. Adjustable-rate hybrid mortgages were made to subprime borrowers. But they were penalized for refinancing in the first two or three years. And they faced payment hikes of up to 30 percent or more after the starter period.

And now we're seeing a replay with interest-only and negative amortizing mortgages that were made in 2004 and 2005. These "nontraditional" mortgages often doubled the monthly payment. You have to wonder what people were thinking with this kind of arrangement.

We know that those innovations were very popular for a short while as home prices were rising. But it's now abundantly clear that they would fail under virtually any other market conditions. The way these mortgages were structured is just one of many aspects of our mortgage finance system that ran amuck.

There are many lessons to be learned about consumer protection ... capital market instruments ... financial incentives ... risk management practices ... liquidity management ... and how to service distressed loans.

Reforming mortgage finance: Five basic principles

So let me focus on the way forward, and some principles for repairing mortgage finance.

First and foremost: Protect the consumer. An affordable loan that the borrower can pay over the long term has always been the linchpin of the mortgage finance system.

As we now know, in recent years, many mortgage brokers weren't thinking about affordability when giving out tens of thousands of no doc, no down payment loans.

They also didn't consider whether consumers understood how they loan worked. A loan that is so complex that the borrower cannot understand its terms cannot serve the long-term interests of the borrower or the lender. A loan where the payment suddenly jumps by a large amount can't serve anyone's long-term interests. And the same can be said for loans that skimp on documentation or press the envelope with regard to debt service.

Protecting the consumer from such perils is not simply a do-good public service. In fact, consumer protection, and safe and sound lending practices are two sides of the same coin. Lenders who put their retail customers at risk also put themselves, their investors, and our entire financial system in danger.

The second principle is: Keep it simple. In short, we should heed one of Warren Buffet's investment principles: If you don't understand it inside and out, don't buy it.

In the last 20 years or so, innovation and deregulation have made more credit available through more channels to more people and businesses than ever before. These have generally been positive developments. The same can be said for risk management techniques and derivative instruments that are used to hedge credit and interest-rate risk. But as many of these products have evolved, many have become enormously complex. And that's created excessive risk.

Borrowers have had trouble understanding complex mortgages with confusing names like "hybrid arms" "options arms" and "negative amortization".

Even some of the smartest people on the planet – including highly sophisticated investors – have had trouble understanding structured finance, and derivatives instruments such as collateralized debt obligations, and credit-default swaps.

Last year, NABE surveyed its own members – some of the people in this very room. You were asked how much you knew and understood the structures, activities, and risks associated with complex financial instruments and institutions.

Despite the fact that most of your members hold advanced degrees in economics or business , some 68 percent of you confessed ... to your credit ... that you had little or no knowledge of how credit-default swaps work. Fifty-one percent said the same about CDOs. Forty-eight percent didn't understand asset-backed securitization. And forty-five percent had little knowledge about the workings of hedge funds.

Going forward, we need to develop critical threshold tests for any financial innovation: Efficient markets work on the ability of all market participants to accurately understand and price risk. If investors, ratings agencies, executive management, regulators and even economists can't understand the risks, we're bound to invite confusion and mistrust.

Despite the many benefits that financial innovation has created, we are left with a major problem: Products and processes that are so complex and so opaque that even our best minds don't understand them. If the market cannot see and digest the risks associated with financial products, the market cannot work.

Going forward, we need to get back-to-basics in promoting products and services which the market can understand. For derivatives in particular, we need to promote exchange type mechanisms to facilitate more liquid trading of standardized products. These

mechanisms should include large trader reporting ... prudential margin requirements ... strong anti-fraud and anti-manipulation provisions ... and a greater level of government oversight and enforcement.

Principle number three: Reduce leverage.

The first rule of finance is that leverage breeds risk. But it's a lesson soon forgotten during the good times, when the economy is growing and people are making money. It holds true for everyone – consumers, investors, and financial institutions of all types.

Lending 100 percent of the value of a home, essentially doing away with the down payment, is always a bad practice, now matter how fast the housing market is growing. For financial institutions, equity capital is an essential cushion for weathering difficult times. Insured depository institutions in general have greater constraints on leverage than other types of financial institutions. Our relatively strong capital requirements have served banks well during this crisis.

But the allure of leverage was a siren's song for financial institutions during the recent "great moderation" of economic growth, leading them to seek higher returns without proper regard for the risks. Now many of them are on the rocks.

So we need to build better safeguards that prevent leverage from getting out of hand. Excess leverage is a danger to the system as a whole. That's the big lesson of 2008. And for the economy, the system-wide pain of de-leveraging after years of financial excess is huge.

Principal number four: Create the right incentives.

As technology and innovation has allowed the unbundling of the mortgage credit process ... separating origination, funding and servicing ... we now have many more players in the game. Some get paid early in the process, when the loan is originated and the mortgage-back securities underwritten. Others, namely the borrowers and the investors, have a much longer-term stake in the outcome.

What has become clear during the recent crisis is that the financial interests of all these players can be conflicting. Originators and underwriters often have the incentive to make riskier loans that don't serve the long-term interests of borrowers and investors.

If we want private securitization to ever work again, we need a workable compensation scheme that aligns the interests of all the players in the game.

Loan servicers, too, may have incentive problems because of conflicting interests between senior and subordinate investors.

While modifying problem loans (instead of foreclosure) can minimize credit losses for a mortgage pool as a whole ... servicers have been reluctant to deviate from the standard practice of foreclosure ... even as housing markets continue to sink.

This is why the FDIC has consistently encouraged servicers to use whatever authority they already have to systematically modify delinquent loans.

And we practice what we preach. We're systematically modifying troubled loans that we currently manage at IndyMac Federal Bank.

Principal number five: Don't take liquidity for granted.

One of the enduring lessons of this crisis is that many financial institutions took for granted their access to funding, and the stability of secondary markets for mortgage-related assets. During the boom, issuers and investors alike assumed that mortgage-related assets would always find a ready market. Why? I guess because they figured mortgage-related assets were good as gold.

They failed to see that the increasingly risky loans they were making, and the complex securities they were issuing, could only perform if home prices kept rising. But, of course they didn't. And this is now the core problem we're facing. When the housing market turned, the capital markets turned their backs on these instruments. And many institutions did not have a "Plan B" for liquidity.

The lesson here is that the liquidity of our financial markets is a vital resource that all of us depend on. And at the end of the day, liquidity is only as stable as our institutional practices, and the public's confidence in those practices.

How the Future Will Be Won

So, how do we apply these five basic principles? How do we reform the rules for consumer protection and sound underwriting? And how do we improve transparency and align incentives?

In a time of crisis, the immediate impulse is to tighten the regulatory screws. Yes, tougher regulation is absolutely needed. We especially need to plug the gaps that allowed regulatory arbitrage, which is one of the root causes of the explosion in subprime lending that triggered the housing meltdown. But let me stress that we don't necessarily need more regulation, but smarter regulation. Remember how we came by the practices that served us so well in the immediate post-war period, and in the period of innovation that followed.

Effective standards for consumer protection, safe and sound lending, disclosure, risk management and transparency were not simply imposed by regulatory fiat. Instead, they were carefully developed over time as a matter of industry best practice, market

discipline, and effective regulation. Once again, these forces will need to work together as we rebuild our mortgage finance system.

Conclusion

This is where an organization like yours can make a real difference. By standing up for best practices ... by understanding the importance of consumer protection ... by calling attention to the perils of complexity, you can actively discourage the risky behavior that led us to where we are today.

You're not only experts on economic policy. You're opinion leaders. Where higher standards for marketplace behavior and for self-regulation are needed, you are in a position to define them, and to defend them. And there is no question that when industry imposes higher standards on itself, regulation can be both more effective and less intrusive.

We have a lot of work to do. But Americans have always been problem solvers. We must deal directly with today's pressing problems. We must be confident that our governing institutions are strong and that we have successfully dealt with the great challenges of the past. And even as we do, we must keep thinking about homeownership and the major task ahead of rebuilding mortgage lending for the future. Thank you very much.

Last Updated 10/6/2008