Financial Innovation: Benefits and Challenges

Additional Information

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Introduction

Some of you, like me, have been around long enough to remember when the community affairs debate centered around increasing access to capital and credit markets and easing restrictions on lending. We know that people on the financial margins just didn't have all that many borrowing options a generation ago.

With the benefit of legislation like the Community Reinvestment Act, which we will hear more about this morning, access to credit and capital has gradually improved. Now, people at all ends of the financial spectrum have more opportunity to become homeowners than they did 30 years ago. In the past few years, the U.S. homeownership rate has reached its highest level in history - nearly 70 percent.

But clearly, not all of the news is positive. Much of yesterday's agenda focused on home foreclosures-a topic that has been getting quite of bit of attention lately, and I think deservedly so. From our communities to Congress, there is considerable concern about how the increasing numbers of home foreclosures are affecting borrowers and neighborhoods. Unfortunately, this problem hits very close to home. In the fourth quarter of 2006, Ohio had the highest foreclosure rate of any state in the nation. We know that Cuyahoga County itself has been particularly hard hit. It is unfortunate that at a time when many people are rediscovering the hidden potential of our urban neighborhoods, the current trend in foreclosures might compromise some of the real progress that has been made.

At the Federal Reserve Bank of Cleveland, we care about this problem. Some of you here this morning have participated in meetings we have held over the past few years with community leaders, bankers, academics, regulators, and other policymakers. Our discussions have reinforced the idea that the housing market is very complex, with many participants and many competing interests.

And that leads me to my message this morning: Within this increasingly complex mortgage market, policymakers must preserve the benefits of financial innovation while protecting consumers from unfair and abusive practices.

Obviously, this is a broad topic, and I will only be able to touch on a few related factors this morning. First, I will discuss some of the benefits and challenges brought by legal changes and financial innovation. Then I will describe how information problems in the market have led to some unintended consequences. Finally, I will explain why curing the ills in mortgage markets will require a comprehensive approach. Please understand that the Federal Reserve

Banks are not rule-makers; that authority rests with the Board of Governors in Washington.

The Impact of Legal Changes and Financial Innovation

Today's mortgage markets have been shaped by legal changes and financial innovation. Over the past few decades, a series of legal changes has led to the removal of state interest-rate caps and the introduction of variable interest rates and balloon payments. While these changes have provided more payment options and broader access to homeownership, they have also resulted in a very complex market, which brings its own challenges. For example, adjustable-rate mortgages are more complex instruments than fixed-rate mortgages and can sometimes be more difficult for consumers to understand.

Financial innovation has been a major driver of change as well. Innovation allows markets to craft specialized mortgage contracts and to transfer risk. For example, many mortgages are now pooled, repackaged and sold as mortgage-backed securities. Compare this to the days when a borrower just walked into a bank branch, signed up for a loan, and knew that the same bank would hold the loan to its full maturity.

Financial innovation has clearly benefited consumers by driving down costs. Since 1985, initial fees for conventional mortgage loans have fallen from roughly 2.5 percent of the loan balance to about 0.5 percent.[1] Another big advantage is choice. A few decades ago, people were offered just one or two different mortgage products, but now they can choose from among multiple instruments and payback structures. Finally, consumers benefit from faster loan decisions today.

The combination of legal changes and financial innovation has brought a big increase in the number of players in the mortgage market - including brokers, underwriters, servicers, and rating agencies. This evolution allows for more specialization and a greater volume of lending. But it also brings new challenges in terms of conflicting incentives. For example, because a mortgage broker is typically compensated only when a loan is made, he has an incentive to approve the loan. However, this incentive may conflict with the interests of the potential borrower, who may not be able to afford the loan. This incentive may even conflict with the interests of the lender, who is looking for repayment of the loan principal, rather than just the loan origination.

Conflicting incentives and greater complexity are just two of the challenges that go along with the many benefits of legal changes and financial innovation.

Information Problems in Mortgage Markets

Another challenge is posed by information problems in the mortgage markets, which can lead to unintended consequences. These problems can exist between borrowers and lenders, or they can arise from incomplete information about what is happening in mortgage markets more broadly.

One information problem we have seen between borrowers and lenders is an imperfect estimation of borrowers' ability to repay adjustable-rate loans. The Mortgage Bankers Association has reported that in both the prime and subprime markets, the share of adjustable-rate loans entering foreclosure was more than two-and-a-half times the share of fixed-rate loans entering foreclosure in the fourth quarter of 2006.

The difference in foreclosure rates between these two types of instruments is striking. It suggests that some borrowers and originators may have misunderstood or miscalculated the increases in interest rates that could occur with adjustable-rate mortgages.

We know that information problems can run the spectrum from simple miscalculations to withholding of information to outright fraud. Let's consider a case of withholding information. On one side, borrowers may have a better idea about the risks they face in repaying their debt than creditors do. As a result, borrowers may have a disincentive to fully reveal this information because it may jeopardize their ability to obtain the loan.

On the other side, lenders may have an information advantage as well. Because they generally have superior knowledge of financial instruments and markets, lenders may not reveal certain information to borrowers that would reduce the profitability of the loan. For example, a lender might recommend a near-prime or subprime loan when a borrower could in fact qualify for a prime loan. This information advantage can cross the line into outright fraud if unscrupulous lenders mislead borrowers about the actual cost of a loan, with the goal of stripping equity from a home. In other cases, borrowers or originators may misrepresent the borrower's income in order to secure a loan.

Unfortunately, we cannot be sure how prevalent any of these practices may be. This brings me to another, broader kind of information problem - incomplete information about what is taking place in the various segments of the mortgage market itself. Certainly we receive useful information from trade associations, private data vendors, and government agencies, but many people are unaware that data reporting results differ widely among these sources. Consequently, our picture is incomplete. For example, there is no standard definition of a subprime loan, and there is no single, definitive source for foreclosure data. Right now, much of the foreclosure data is being reported in the context of anecdotal evidence.

While anecdotal evidence helps us identify factors that correlate with foreclosures, it does not permit us to determine to what extent each factor actually causes the foreclosure problem. Foreclosure rates may vary depending on local economic conditions, state laws, underwriting practices, and the personal situations of borrowers, such as family illness or job loss. Understanding the mix of factors and their contribution to the problem is critical to identifying the right policy prescriptions.

Response to Mortgage Market Problems Requires a Comprehensive Approach

Just as there is no single cause of the problems we are seeing in the mortgage market, I am convinced that there is no single solution or "silver bullet" that will cure them. Curing the ills in the mortgage markets will require a comprehensive approach, and each player in the financial arena has a role to play.

First, consumers must take responsibility for understanding their financial transactions and indeed, for increasing their own basic financial literacy. Beyond simply weighing the relative costs of similar products and setting up a household budget, consumers should understand the importance of setting longer-term financial goals and developing a plan to meet those goals.

Second, financial services providers, including mortgage brokers, should continue to promote greater understanding of the terms of the products and services they offer. They should clarify information about the financial products being offered, including the potential ramifications over both the short term and the long term. Only then can consumers make a truly informed decision about the financial instruments they are considering.

Finally, regulators have a critical role to play. Many agencies are involved at both the federal and state level. These agencies must continually review the relevant laws governing financial markets to ensure these regulations evolve along with the complexity and pace of change in the financial services industry. Some positive actions are already taking place. For example, the federal banking regulatory agencies have recently proposed additional guidance regarding subprime mortgage lending. This guidance outlines expectations for sound risk management, control processes, underwriting standards for adjustable-rate mortgages, and clear customer communications.

At the Federal Reserve, the Board of Governors is carefully considering how it might further use its rulemaking authority under the Home Ownership Equity Protection Act to curb abusive lending practices without discouraging responsible subprime lending. In fact, a public hearing was held in Washington just last week. The Board is also reviewing disclosures under the Truth-in-Lending Act to ensure that lenders provide consumers with the right information at the right time during the mortgage-selection process.

Of course, it is not enough just to monitor laws and regulations - they must be effectively enforced. Responsibility for enforcing the rules is shared among the five federal regulators of depository institutions, the Federal Trade Commission, and state authorities. The Federal Reserve is committed to working closely with these other regulators to ensure the laws protecting consumers are effectively enforced.

Finally, any new laws, regulations, or guidelines should be developed with the thought of aligning appropriate incentives with the desired behaviors of the affected parties. Without this alignment, we can expect to see unintended outcomes, such as a restriction of credit for otherwise creditworthy borrowers.

Conclusion

As we consider these issues, I think it is important to keep in mind the overall outcome we are trying to achieve, which is the efficient and effective flow of credit and capital. We must strive to ensure continued access to our financial markets while protecting consumers and communities against unfair and abusive practices. Fully understanding all of the factors behind the problems we face in the mortgage market, without curtailing financial innovation, is an important means to that end.

1 Source: Federal Housing Finance Board.