Reflections on the Mortgage Market

Additional Information

Sandra Pianalto

President and CEO,
Federal Reserve Bank of Cleveland

Neighborhood Housing Services of Greater Cleveland Annual Luncheon

Cleveland, OH

February 8, 2008

Introduction

We all know that over time, markets and policies undergo change, but some things will always remain constant. One is Neighborhood Housing Services' (NHS) commitment to promote sustainable homeownership. Another is the Federal Reserve's commitment to foster the availability of credit and banking services in low- and moderate-income communities. These are worthy goals in both good times and bad.

As all of us know only too well, one of the most pressing issues facing our nation and our local communities here in Northeast Ohio is the rapid deterioration in the housing sector. The housing slump, and its spillover into the financial markets, is the largest factor behind the current economic slowdown. Our financial markets have been unsettled since last August by the impact of mortgage-related losses on financial institutions. Many lenders are tightening their standards and lowering their risk profiles, which is affecting spending in the overall economy.

In Ohio, more than 20 percent of the subprime adjustable-rate mortgages have fallen into delinquency. Foreclosure rates have reached a 30-year high, and the once-healthy markets on the coasts are rapidly catching up with us.

Most people I talk to these days are asking me two questions about the current housing situation: How did it happen and what have we learned? Those are the questions I would like to address in my remarks today.

I will begin by sharing my views on how financial innovation has reshaped the mortgage market over the past few decades. Then I will talk about the promises and pitfalls of that innovation and about how the current situation in the mortgage market has unfolded. Finally, I will describe ideas that have been proposed to protect consumers while preserving the availability of mortgage credit.

Please understand that my remarks today are my own and do not necessarily reflect the views of my colleagues in the Federal Reserve System.

Financial Innovation and the Mortgage Revolution

Financial innovation has truly revolutionized the way we finance our homes. Just a few decades ago, when many of us were buying our first homes, the mortgage process was much different than the one that exists today. Our mortgages came with fixed rates and we had to come up with a 20 percent down payment. Our local mortgage lender originated, funded, and serviced the loan. That lender funded the loan mainly with deposits and held the loan until we paid it off.

What a difference a decade or two makes. Today, different parties originate, package, guarantee, and service loans. Investment banks can slice and dice mortgages into risk categories, package them into mortgage-backed securities, and sell them to investors around the world. As a result, huge sums of money have flowed into the U.S. housing market during the past several years. At the end of 1995, investors owned $194 billion worth of home mortgages packaged as mortgage-backed securities. Ten years later, that number had skyrocketed by about tenfold, to $1.6 trillion.

Partly as a result of these financial innovations and partly as a result of the lowest interest rates in a generation, loans to increasingly riskier borrowers were funded. As this happened, the door of homeownership was swung open to millions of households for the first time. Homeownership rates increased by an amazing 4 percentage points within one decade - up to about 69 percent in 2006.

Unfortunately for many people, the dream of homeownership has been tarnished by an explosion of defaults and foreclosures. Ongoing problems in the subprime market have spilled over into neighborhoods, the broader financial markets, and our economy. In the fourth quarter of last year, the nation's homeownership rate declined back to its 2002 level.

I have seen the devastation of some of Cleveland's neighborhoods, and I am especially dismayed that so much of the good work resulting from the partnerships between banks and community-based organizations has been undermined by these problems.

Promises and Pitfalls of Innovation

What went wrong? Unfortunately, the recent housing boom, which seemed like a surefire win for lenders and borrowers, also masked some critical flaws in the global mortgage-financing system.

Let’s look at some basic assumptions of this system. For the system to work smoothly, a vast network of participants - brokers, appraisers, lenders, rating agencies, insurers, and investors - all must manage their risks. To do this, they must make assumptions about the performance of individual loans under various economic scenarios. They must also make assumptions about the performance of the financial markets as a whole when circumstances change.

When financial instruments are new and complex, assumptions about risk and about how borrowers will perform under duress have not yet been stress-tested. When home prices are rising and interest rates are falling, loan losses are expected to be low. But when home prices are falling and interest rates are rising, loan losses often turn out to be much higher than anticipated.

The seemingly flawless functioning of the system during the housing boom may have led people to underestimate the risks they were facing. Lenders assumed that brokers and appraisers would practice due diligence in evaluating the borrowers and their properties. Investors, in turn, assumed that lenders would work only with reputable brokers and that ratings agencies could accurately measure risk.

We also know that some mortgage brokers clearly did not have the best interests of their borrowers at heart. In boom times, it was easy to concentrate on generating fee income through high volumes rather than focusing on whether certain borrowers were truly ready to become homeowners.

For their part, some borrowers who had sudden access to easy mortgage credit failed to realize the heavy risks they were taking on with subprime, adjustable-rate mortgages that would reset to much higher rates. Expecting that home prices would continue to rise and that mortgage rates would remain stable, borrowers thought they could quickly refinance themselves out of trouble.

With the benefit of hindsight, we see the pitfalls that lay just below all of these faulty assumptions. As the housing market stopped appreciating, marginal borrowers and speculators were caught short. It was not long before many homeowners lost either the ability or the incentive to keep their loan payments current.

We now realize that at some point, for many of the players in the mortgage market, optimism turned into euphoria, calculated risk-taking turned into over-reaching, and healthy doses of skepticism turned into overconfidence. Today, we are left with the damage that has been caused by faulty assumptions and bad choices.

Where Do We Go from Here?

Clearly, there is much work to do. A comprehensive approach is needed to address the problems we are now facing in the mortgage market. Providers of financial services must promote a greater understanding of the terms of the products and services they offer. Homeowners must take responsibility for understanding their financial transactions and increasing their financial literacy. And regulators also have a critical role to play. Agencies must review and enforce relevant laws and rules to ensure they evolve along with the complexity and pace of change in the financial services industry.

As you may know, the Board of Governors of the Federal Reserve System recently proposed some comprehensive new rules under the Home Ownership and Equity Protection Act - or HOEPA. The intent is to protect consumers against abusive practices while preserving the availability of mortgage credit. The amendments were developed following a series of public hearings and outreach efforts.

Some of the rules would extend new protections to virtually all subprime borrowers and to other borrowers who qualify for high-priced loans. Specifically, these rules include four key protections:

They prohibit creditors from engaging in a pattern or practice of lending without considering the borrower's ability to pay.

They require creditors to verify the income and assets they rely on to make loans.

They restrict the use of prepayment penalties.

And they require creditors to establish escrow accounts for insurance and taxes.

The Board also proposed rules that apply to most mortgages, including prime, to increase transparency and competition in the market, and to protect borrowers from certain misleading and deceptive practices. These new rules will apply to all mortgage lenders and will give consumers the opportunity to redress wrongs through civil actions.

The proposed HOEPA rules are an important first step to help restore confidence in our mortgage market. To ensure that these rules are as robust as possible, the Board of Governors is looking for comments by April 8th. As always, your ideas are welcomed.

Of course, attacking the housing and mortgage problems we are facing today is a complex matter and requires multiple strategies on both the public and private level. States are strengthening their licensing standards, and financial institutions are taking steps to improve their lending practices. The Federal Reserve has launched a pilot project to collaborate with other state and federal regulatory agencies to conduct consumer-protection compliance reviews of nonbank lenders and other industry participants. Ultimately, the effectiveness of all of these efforts depends on diligent enforcement.

Going forward, it will be important to safeguard the interests of consumers while allowing lenders to continue to serve their communities. We must be careful not to create an environment where lenders are reluctant to serve their subprime customers. We want to encourage responsible lenders to stay in the market and work in partnership with organizations like NeighborWorks America and local affiliates like NHS. Just recently, Congress recognized your expertise by selecting NeighborWorks America to administer a large National Foreclosure Mitigation Counseling program to help struggling homeowners.

At the Federal Reserve Bank of Cleveland, we share your belief that good pre-purchase counseling combined with the right loan products result in successful borrowers. And, like you, we remain convinced that successful homeownership is still the cornerstone of community revitalization. The partnerships between the banks and organizations represented here today are a testament to the imagination and determination of Clevelanders.

Conclusion

There is no denying that we are going through some very difficult times right now. The challenges facing our region, in particular, are very personal to me. I grew up in Northeast Ohio, I went to school here, and I have spent most of my working life here. Like you, I want everyone to have the opportunity to realize his or her own version of the American dream.

There will come a time when we will turn the corner on this difficult period. As long as we regulate wisely and do not suffocate our credit markets, the very real hardships of adjustment will fade, and we will all benefit from the new practices that emerge.