Housing and the Federal Reserve

Additional Information

Sandra Pianalto

President and CEO,
Federal Reserve Bank of Cleveland

Ohio Housing Finance Agency and Ohio Capital Corporation for Housing

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Introduction

I am very pleased to be here today to participate in this 11th annual Ohio Housing Conference, but I wish we were coming together under different circumstances. As everyone in this room knows all too well, we are just now beginning to emerge from the most severe economic crisis to hit this country since the Great Depression. And though we have seen some signs that the worst may be over, the housing industry is not out of the woods yet; nor is the broader economy.

I'm sure that everyone in this room has been challenged in some way by the events of the past few years. As a national policymaker, living through this crisis has been a humbling experience. It has been sobering to realize that financial market participants and regulators alike did not fully appreciate how complex and interconnected our financial markets had become. Nor did we fully appreciate how much risk was building up in the financial system. These are a few of the many lessons all of us have learned over the past couple of years.

At the Federal Reserve, we now have a better understanding of the conditions that led to the challenges we face, but understanding alone isn't enough. We have been responding vigorously on many fronts, and there is still more work to do. I know that all of you in this room have also been spending endless hours working to find solutions to the problems of delinquencies, foreclosures, and access to credit. Progress is being made, but it will take the work of many and a considerable amount of time for housing markets to fully recover.

Today I will talk about some of the Federal Reserve's efforts. I will first discuss the role of the Federal Reserve as a monetary policymaker and the actions we have been taking to put the economy on the road to recovery. I will then speak about the regulatory steps we are taking to ensure the safety of the financial sector and to protect consumers and borrowers. I will conclude by telling you about our activities here in Ohio and across our Federal Reserve District as a community development partner.

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

Monetary Policy

Let me begin, then, with our monetary policy response. The combination of this severe housing contraction and the steep national recession is not a coincidence. During the boom years leading up to this debacle, housing finance became intertwined with broader financial and economic developments. Rising property values supported more consumer spending, banking profits, and more lending of all kinds. When this growth cycle began to unwind, and spin in the other direction, mortgage-related losses eroded the capital of many financial institutions and cut deeply into the wealth of many homeowners. These problems led financial institutions to reduce lending to consumers and businesses, and induced consumers to curtail their spending. Weakness in the housing markets restrained the broader economy which, in turn, further weakened the housing markets.

As you know, the Federal Reserve has taken historic measures to address these problems. Monetary policy is the responsibility of the Federal Open Market Committee, or FOMC, which consists of the members of the Board of Governors in Washington and the 12 Reserve Bank presidents from across the nation. This decentralized structure ensures that the Committee takes into account Main Street as well as Wall Street. The FOMC has a dual mandate from Congress—to maintain price stability and to promote maximum sustainable economic growth.

When economic activity weakens, the FOMC typically lowers its short-term policy target, known as the federal funds rate, and this time was no exception. As the outlook for the economy deteriorated, the FOMC repeatedly cut the federal funds rate target, and it now stands at essentially zero.

This recession has been far from a typical one, however. Many financial markets seized up, crippling the flow of credit to many parts of the economy, including such important Main Street activities as housing finance, auto loans and even student loans. Federal Reserve officials knew that we had to do more than rely on interest-rate actions alone. Beginning in the spring of 2008, we designed a number of new lending programs and facilities to get credit flowing once again to these important financial markets. Our objective was to help thaw a broad range of financial markets and steer the wider economy away from a cliff.

We have also taken unprecedented steps in how we conduct monetary policy. For instance, we have been purchasing mortgage-backed securities issued by the government-sponsored enterprises Freddie Mac, Fannie Mae, and Ginnie Mae. Our strategy has been to reduce the cost and increase the availability of credit for home purchases, which we expected would support housing and financial markets more generally. We are now well into this program, which will culminate in the purchase of $1.25 trillion in agency mortgage-backed securities by next spring. Today, mortgage rates stand more than a full percentage point lower than they were one year ago.

Fortunately, we have seen some recent progress in the housing sector. Housing prices and sales levels have begun to stabilize, and in the first half of the year, refinancing was up by more than 150 percent, which has lowered the debt burden of many homeowners. Of course, the Administration and Congress also had a strong hand in helping to stabilize real estate markets-most notably with the first-time home-buyer tax credit. The combined efforts of these initiatives seem to be working. Three out of five home sales are now to first-time buyers, compared with one in five in a typical market. But this also illustrates for me that many move-up home purchasers are still sitting on the sidelines, so there is a long way to go before anyone can breathe a sigh of relief.

At this point, monetary policy can most effectively support the housing sector by fostering stronger growth in the broader economy, which would lead to more stable property values, increased consumer confidence, and lower unemployment. Economic conditions have certainly improved since the beginning of this year, but resource utilization levels still remain low, bank lending is restrained, and credit terms are tight. I expect our recovery to be a gradual and bumpy one.

Regulatory Issues

Of course, the work of the Federal Reserve affects the housing sector in ways other than through monetary policy. So let me now turn to the Federal Reserve's supervisory and regulatory roles. While much of the initial financial crisis originated in the mortgage markets, there is still much to correct there and in the broader financial markets.

Everyone with a role and a stake in the financial system needs to take a careful look at the various failures of market incentives and regulations that supported mortgages and securities that are now being described as "toxic." In looking at what went wrong, we need to react in a thorough and thoughtful manner to limit similar problems in the future. We at the Federal Reserve have been examining our past actions to understand where opportunities are available for strengthening our supervisory approach. Where we can act under existing authorities, we are taking strong steps to make our financial system safe, sound, and fair.

We have broadened the scope of our supervision. For example, we have heard complaints that while a given bank might be complying with regulations, one of the same bank's holding company affiliates might not be. To address this issue, two months ago the Federal Reserve announced that we will conduct consumer compliance exams of nonbank subsidiaries of bank holding companies and foreign banking organizations, and we will investigate consumer complaints against them. Our goal is to ensure consistent practices within all subsidiaries of bank holding companies, not just banks.

In addition to these and other supervisory efforts, the Federal Reserve has adopted new regulations and revised existing ones to protect consumers. In July 2008, the Federal Reserve strengthened a key regulation designed to protect consumers in the mortgage market from unfair, abusive, or deceptive lending and servicing practices. The rule also establishes advertising standards, requires certain mortgage disclosures to be given to consumers earlier in the transaction, and adds important protections for a newly defined category of "higher-priced mortgage loans." When developing new regulations, the Board of Governors is working carefully and creatively to craft regulations that people can better understand—even using consumer focus groups to give us feedback on the clarity of our proposals.

Many of you are also aware that the Federal Reserve has rule-writing authority for the provisions of the Community Reinvestment Act (CRA). The CRA has been a significant driver of access to credit and capital in traditionally under-served communities since it was passed in 1977. Yet, as we're all aware, the financial services landscape has changed dramatically in the past 30 years, and the problems we face are now different.

For example, there is evidence that CRA is of limited use in addressing the problem of foreclosure spillovers, especially when it comes to dealing with real-estate-owned—or REO—properties and the disposition of vacant properties. This is an especially important issue for Ohio, which is saddled with a very high inventory of REO properties.

As you know, the CRA was designed to encourage banks to support building and renovation, not to tear down dilapidated housing. But one of the CRA's hallmarks is its flexibility. There may be ways to adapt the regulation to encourage lenders to support the kinds of housing activities that many communities need in this time of crisis. I think the CRA can become a more effective tool in providing incentives for banks to donate some of the distressed real estate they own to qualified community development corporations, and to engage in services and investments that benefit foreclosure mitigation and neighborhood recovery efforts. The Federal Reserve Bank of Cleveland is currently working with others on a practical way to adapt the CRA for these purposes, although ultimately, changes in CRA regulations involve the other bank regulatory agencies in addition to the Federal Reserve.

Community Development

While these efforts are important, regulation alone is not a panacea and often only addresses problems after they become problems. Despite renewed activity on the regulatory front by the Federal Reserve and others, we need strategies to tackle the wider housing challenges of today and tomorrow. This raises the third area of focus for the Federal Reserve: our work as a community development partner.

Through the Community Development function at each of the 12 Reserve Banks, the Federal Reserve maintains relationships with community and economic development practitioners. We regularly share our findings with bankers and legislators at the state and national levels, and with our colleagues at the Board of Governors in Washington. And we use the knowledge we gain from working with you to inform our supervisory and regulatory policy responsibilities.

We also apply this knowledge in our work with other government agencies at all levels to promote community development. This leads to more flexible and targeted solutions that can make a difference in the neighborhoods where you work.

At the Federal Reserve Bank of Cleveland, a critical theme that has surfaced from our community development work—and that continues to guide our efforts—is that recovery in Ohio will be affected by the challenges we face as a slow-growth region, where population declines over the years left a serious excess of housing well before the crisis began.

Even though Ohio never experienced the sharp appreciation in housing prices that other parts of the country did earlier in this decade, the pain of the crisis has been just as real here, if not more so. In some parts of Ohio, housing sales began to weaken as early as 2004. Simply put, Ohio's problems are more entrenched because they are tied to structural and not just cyclical weaknesses in the state's economy.

This makes it all the more necessary to investigate what housing programs might work within our region. Last November, we held a series of public events to connect distressed borrowers, counselors, and loan servicers to find ways to keep people in their homes. At that time, we thought loan modifications would prove to be an important tool for stabilizing the housing market. Outreach to distressed borrowers has met with mixed success, and only a very small percentage of distressed loans has been modified successfully across the nation--and the figure has been even lower here in Ohio.

Well-intended efforts often don't work well in practice for any number of reasons. We discovered a variety of factors that inhibited the loan modification process, some of which are currently being addressed by lenders, servicers, counseling agencies, and program administrators. Other factors are not so easily addressed, such as the fact that many of the mortgage loans that borrowers received were poorly underwritten in the first place. And there are new impediments. We are now finding that the reason most borrowers give for needing assistance is a loss in income due to the recession. In other words, the weak economy itself is generating more distressed borrowers, adding to the existing problems within the housing and mortgage industries. We know that loan modifications alone will not be enough to address the crisis.

If a homeowner cannot avoid foreclosure and has to leave his or her home, what happens to the property if it happens to be in a place where there is either no ready buyer or simply too few people left to occupy yet one more empty house among many others? The Neighborhood Stabilization Program, or NSP, was put in place to help municipalities acquire such properties for possible rehabilitation and resale, or in some cases, demolition and land banking. The Federal Reserve Bank of Cleveland and the Federal Reserve Bank of Richmond are partnering with the National Vacant Properties Campaign to conduct case studies of different kinds of communities that receive NSP funds to find out where the NSP is working, and where improvements might need to be made. We are sharing our findings here, in our region, and also with the Department of Housing and Urban Development.

Our Community Development office also conducts research and analyzes data to uncover patterns, trends, and relationships in the housing markets. Through this body of knowledge, we are gaining valuable insight into other potential solutions, where problems are occurring, and whether there are any similarities or differences throughout the region that can help improve public policy.

Let me share an example of this approach in practice. Data analysis is helping us uncover what factors contributed to very different foreclosure rates in 2007 among demographically similar neighborhoods in Cleveland and Pittsburgh. Here we have two similar communities that are located in different states, with different legal and regulatory environments. Yet Cleveland's foreclosure rates are far greater than Pittsburgh's, especially in poor neighborhoods.

One major discovery of our research was that most of the mortgage lending in Cleveland's poorest areas was originated by a small number of nonbank mortgage companies. However, this source of lending was not nearly as much of a problem in Pittsburgh. Residents of poor Cleveland neighborhoods appear to have less access to, or less reliance on, traditional financial service providers.

We are working to understand why such differences exist between the foreclosure experiences of these two communities and where some improvements might be found, such as in the way states regulate and supervise the mortgage origination process. Other opportunities might be found in homeowner counseling and assistance programs. Our Bank's research is now focusing on specific aspects of prevention, regulation, and enforcement measures across states that might help explain differences in foreclosure experiences. State and local policymakers have told us that the information from this research has been useful in helping shape regulatory proposals and homeowner assistance programs.

The work undertaken by the Federal Reserve in the area of community development aims to help low- and moderate-income communities, but none of our community development efforts can possibly offset the losses and hardship that these communities have experienced. Decades of progress have been wiped away in many low-income communities in this dramatic two-year burst of foreclosures. The Federal Reserve's activities are only a small part of a wider effort involving all of you.

Conclusion

In conclusion, I want to emphasize that the Federal Reserve recognizes the need for action and that we have been aggressive in monetary policy, banking supervision, consumer protection regulation, and community development. Collectively, these efforts are designed to help restore housing markets in pursuit of a better-functioning economy. However, the scale of the recession, the financial turmoil, and the focused impact of the crisis on many communities pose an unprecedented challenge to all policymakers. While we certainly see ourselves as part of the solution, many partners and much time will be needed to heal these problems.

It's going to take a creative, coordinated and collaborative effort to get our housing market back on track—especially here in Ohio. That's why I encourage you to please keep knocking at our door. Let us know what you're thinking, what you're finding, and how you think we can help.