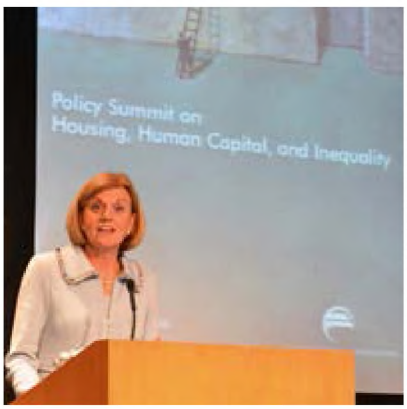
Looking for Common Ground and New Solutions in Household and Consumer Finance



I am delighted to welcome you to our 11th Policy Summit, and I am particularly pleased to welcome our new partners from the Federal Reserve Bank of Philadelphia in sponsoring this signature conference. I look forward every year to hearing the discussions from the talented mix of researchers and practitioners who participate in this conference. Your presentations and conversations have often helped focus our community development efforts in the Federal Reserve System. More importantly, you are a valuable resource for us, and for that I thank you.

Some of you may know that I am retiring early next year, so I will not be here as president of the Federal Reserve Bank of Cleveland at the next Policy Summit. I would like to use this occasion to reflect on some of the lessons I have learned during my service, particularly as they relate to topics you will be discussing over the next two days.

Over the past 10 years as president of the Federal Reserve Bank of Cleveland--and really, over my past three decades in the Federal Reserve System--I have come to appreciate the virtues of cooperation and finding shared ground. Around the Federal Open Market Committee table, where monetary policy is set for this country, I have seen first-hand the importance of looking at issues from different perspectives and building consensus around new approaches. There were times during the thick of the financial crisis when the stakes were high and difficult decisions needed to be made quickly. Under the leadership of Chairman Ben Bernanke, my colleagues and I came together to initiate swift and aggressive responses, often using unconventional and innovative tools. I think it is widely acknowledged that the Federal Reserve's actions helped prevent an even bigger crisis, and put the nation's economy on a path to recovery. We would not have been able to accomplish what we did without being open to different points of view, being willing to put new ideas into practice, and recognizing that we each wanted to do what was best for our country.

Today, I want to discuss the importance of building consensus around new approaches to overcoming the challenges we face in modernizing

Additional Information

Sandra Pianalto

President and CEO,
Federal Reserve Bank of Cleveland

2013 Policy Summit on Housing, Human Capital, and Inequality

The Intercontinental Hotel & Conference Center Cleveland, Ohio

September 19, 2013

housing and consumer finance policies. I will begin by providing a snapshot of today's financial services landscape. Then I will highlight several recent cases where people with different perspectives are reaching agreement on solutions to some stubborn housing problems. I will conclude by suggesting a common effort where an open-minded approach might be especially valuable. As always, the views I express today are mine and not necessarily those of my colleagues in the Federal Reserve System.

It is no exaggeration to say the financial crisis was a game-changer. The market failures were vast and well-documented, particularly in the housing finance marketplace. In response to the crisis, Congress passed sweeping legislation to govern the financial services industry, chiefly through the Dodd-Frank Act of 2010.

The impact of Dodd Frank and other legislation motivated by the crisis provides the backdrop for many topics at this Policy Summit. For example, Dodd Frank established an entirely new agency, the Consumer Financial Protection Bureau, to regulate financial products. Among the Bureau's new rules is a measure aimed at making qualified mortgage loans safer for borrowers. Additional regulations on mortgages and other products are designed to promote the stability of the entire financial system. And soon, Congress will be debating serious proposals for reforming the government-sponsored enterprises Fannie Mae and Freddie Mac.

In some ways, the response to the financial crisis has reinforced long-held views about the role of government in the financial system. Those who favor stronger regulations see the response as appropriate to ensure that markets operate fairly for everyone, and at the same time, are more stable. Those who favor a limited role for government see the response as likely to distort markets, hamper credit availability, and substitute the government's judgment for decisions that should be made in free markets.

Emotions still run strong. Consumers' distrust of the financial services industry is high--only one in four Americans say they have a positive view of the banking system. Meanwhile, many in the financial services sector contend that some regulations have been excessive, and may block some people from access to credit and services that they want, and that they can use responsibly. The challenge now is for the financial services industry and the communities and consumers it serves to move past their entrenched positions and instead work together to find new solutions.

I am optimistic about the possibilities for agreement on new solutions in consumer finance and housing policies because I have seen people with different viewpoints come together to enact policies with substantial benefit.

My optimism stems from observations I have made close to home. As everyone in this room knows, this region has a long-standing problem with vacant and abandoned properties—and this problem was exacerbated by the foreclosure crisis. Empty homes are magnets for crime and they contribute to neighborhood blight. They can be eyesores that bring down nearby property values.

For a long time, the response to vacancy and abandonment was simple: rehabilitation. This strategy was based on the principle that individual blocks of homes could be stabilized through rehabilitation of select vacant properties, with the side benefit that historically significant houses would be saved.

Research by the Cleveland Federal Reserve Bank pointed toward the possibility of an additional approach[1]. We found that property values in some of our older, industrial communities are primarily determined by the desirability of the land underneath the structures. It is not the house itself that has value--it is the land the house stands on. This led us to the counterintuitive concept that the best policy to stabilize neighborhoods may not always be rehabilitation--it may be demolition.

I think it is natural that many people reacted negatively to this idea at first. But the strategy has gained currency over the years, and groups that initially were opposed to any program that would tear down homes rather than try to save them slowly changed their minds. In part, this shift happened because of complementary research that showed how demolitions might work in tandem with other measures to deal with distressed housing. This multipronged effort promised to work to the advantage of all stakeholders--homeowners, bankers, and communities at large.

Land banking is my Exhibit A. Our research strongly suggested that in many communities with weak housing markets, there was an oversupply of housing. This specific situation would not be helped by one-size-fits-all policies; it demanded *tailored* policy support.

Cuyahoga County's pioneering land bank is showing us the right way to do it. The land bank is an entity equipped to acquire distressed properties, clear title defects, and either rehabilitate or demolish structures. This flexibility enables the land bank to make decisions that specifically address the conditions of individual neighborhoods.[2]

If you recall, it was not so many years ago that people in both the financial services industry and public sectors were resistant to the idea of land banking. Financial institutions were initially wary of the impact of land banks on their bottom lines, and community leaders were initially suspicious that land banks would undercut neighborhood revitalization efforts. Yet today, land banks enjoy broad and well-deserved support. The positive impact that land banks can have is evident all over Cuyahoga County. A great illustration of this is happening in East Cleveland, where the county land bank acquired two vacant, condemned apartment buildings, cleared their titles, and demolished them to make way for two new, modern apartment buildings. The vision is that residents of these new units will have easy access to the bustling nearby University Circle development.

Let me give you another example of building consensus on innovative housing policy. We at the Federal Reserve Bank of Cleveland recently have developed what we think are useful ideas for streamlining Ohio's foreclosure process. Over the past year, we traveled across the state to discuss policy options that we believe could enhance foreclosure outcomes.

Many community groups have been skeptical of proposals that would speed up the foreclosure process because of their concern that some borrowers would be unfairly removed from their homes. But we have actually found that for many, "removed" is the wrong term. It turns out that approximately a quarter of borrowers leave their homes <u>before</u> the initiation of foreclosure by the lender, which further extends the length of time properties remain vacant.

The overwhelming conclusion of our research was that it takes too long for loans on abandoned properties to go from delinquency through foreclosure in Ohio. In fact, plans to protect homeowners who have already left their homes could unintentionally create costs to entire communities. These costs include physical damage to properties and downward pressure on the value of neighboring homes. We discovered that many affordable housing advocates, housing lenders, and municipal officials agreed with our ideas. Today, several proposals are being considered at the state level that would accelerate the foreclosure process. The headway we have made is a tribute to the willingness of people to reconsider long-held beliefs when presented with new policy options based on new information.

Land banks and accelerating the foreclosure process on abandoned homes are efforts that I would already put in the win column. On the horizon, I see another challenge that seems ripe for progress: finding new approaches to improve access to affordable rental housing programs.

The first obstacle to overcome in this area is shedding outdated notions about the homeownership society. The financial crisis taught us that homeownership is not for everyone. For many people, renting is the better choice. This shift in attitude could be particularly beneficial for low-income households.

We also know that there are some shortcomings in existing rental programs for low-income households. For too many families, finding affordable rental properties in desirable neighborhoods remains difficult.

As those of you who regularly deal with affordable housing policy know, there are two major rental programs for low-income households. The Housing Choice Voucher is primarily a tenant-based program that lets people choose where they want to live, while the Low Income Housing Tax Credit is a place-based program that subsidizes the rent on some units in housing developments, making them more affordable for renters. Individually, the programs have their own specific strengths and drawbacks. The programs operate under completely different rules and are administered independently of one another.

The tenant-based voucher program, which is targeted primarily at people with very low incomes, offers the most freedom of choice; after all, renters should be able to choose the housing location they believe will most improve their quality of life. Nevertheless, research shows that families who use vouchers often do not experience a better quality of life or financial situation. Too frequently, they cannot find, or do not select, apartments in neighborhoods with better schools, for example, or places where their job prospects would be brighter.

Meanwhile, the tax credit program would seem to be a smart way to make housing units available in places that offer attractive amenities to their residents, and thereby contribute to their residents' economic well-being. Yet research suggests that tax-credit housing programs have a mixed record. Too frequently, they result in subsidized buildings being located in neighborhoods with underperforming schools, or with limited access to jobs and health care. In addition, depending on local market conditions, rents in these buildings may be close to the market rates and not affordable for poor households.

Those who support affordable rental housing programs should want to achieve the same results; namely, clean homes in safer neighborhoods that give tenants better access to good schools, health care, and jobs. So what can be done?

The basic problem we face is that there is a far greater need for affordable rental housing than there is public money being provided. With limited resources, it is critical to look for ways to enhance the flexibility of agencies to administer their funds, and allow the two programs to work more effectively together.

Let me give you an example of an approach at HUD[3] that fosters partnerships at the federal level. HUD has been conducting a demonstration program with select public housing authorities across the country. The program provides the flexibility to combine funds from several different programs so they can be used like "block grants," allowing for more experimentation toward the goal of neighborhood stability. One of the benefits of this approach has been the ability to leverage HUD funds with tax credit projects at the local level to meet community needs. States have the same opportunity with their tax credit programs. We should encourage more new approaches like this.

I know practitioners operate under significant restraints on what they are allowed to do and what they can spend. But in the end, wider access to affordable rental housing by families in need is not just a matter of increasing the resources available; it is about finding creative ways for the nation's affordable rental housing programs to work better and more efficiently together. Let's keep our eye on the broader goal. We want people to live in neighborhoods with high-caliber schools, safer streets, and better employment opportunities. I am confident we can find solutions to achieve this objective.

I have just cited three examples in the housing market--land banking, expedited foreclosures, and affordable rental housing--where cooperation around new ideas promises to make a positive difference, or where such an approach <u>already</u> has made a difference. Let me conclude by suggesting how openness to new ideas can help consumers make better financial choices. Success here could have a lasting impact on the housing market and the overall economy.

We now recognize that vulnerable, under-informed consumers sometimes make decisions that don't serve them well. And no wonder. The financial marketplace is incredibly complex. People do not always understand the obligations they are taking on when they use certain services or buy certain products.

In this environment, certain regulatory protections and oversight are likely to be very helpful to many consumers. That said, and as I have noted, there are some who fear that regulatory overstep could actually hurt consumers by limiting their access to potentially beneficial services. Here, I think all parties--consumers, financial institutions, and regulators--have an opportunity to achieve our individual objectives by working through ideas old and new with a common purpose.

The better informed consumers are about financial products and household budgeting, the better their financial decisions will be. Consumers should be protected from predatory practices, but they should also be informed enough to recognize what services could be financially harmful to them. They need to understand the importance of saving so that they are not forced to go outside of conventional financial services into higher-cost, riskier alternatives. For a long time, we have agreed that there is no substitute for a better-informed consumer.

But there are some thought-provoking implications of new research that I also want to emphasize. Making good financial decisions is not just about providing information and teaching people about financial and legal contracts--it is also about understanding the <u>context</u> in which financial decisions are made. Tomorrow at this conference, the closing session will focus on consumer protection in the new regulatory environment, and the Princeton University psychologist Eldar Shafir will deliver an address on how consumers actually make financial decisions. The closing session and the address will feature the application of behavioral research to policy. Opt-in and opt-out strategies figure prominently in the applications favored by Shafir and others in the realm of behavioral economics. Achieving this kind of financial literacy has elements of corporate responsibility as well as personal responsibility.

Financial institutions have it in their power to get in front of this trend by offering more products with built-in features that are likely to benefit consumers-- features like automatic opt-ins for savings plans when funds from checking accounts are periodically swept into customers' savings accounts. There is no need to wait for regulators to require such behavioral features. And consumer groups should see this as an opportunity to help the financial services industry understand what sort of product designs are most likely to be effective. A little imagination and collaboration could go a long way toward a financial marketplace with fair play, more financially resilient households, and profitable financial institutions.

Let me step back here as I wrap up my remarks and offer a bit of perspective. I realize that my talk today is unlikely to set the newswires on fire: "Federal Reserve Policymaker Calls for….Innovation and Cooperation!" I have read more exciting headlines, to be sure. But I am not interested in capturing headlines. I am interested in sharing my experience as president of the Federal Reserve Bank of Cleveland, which has instilled in me the importance of consensus-building around new and different perspectives.

Too often today, standoffs are the norm. People want to solve problems, but they are unwilling to consider opposing or new viewpoints. This gridlock benefits no one. Thinking beyond our immediate interests is not easy. But the way forward does not have to be a zero-sum game where only one side wins and the other side loses. We have seen the opportunities for win-win solutions with housing policy and we could see the same with many of the areas under discussion at this conference--such as small business lending and most certainly consumer finance. By keeping an open mind to different views and new ideas, we might surprise ourselves with how much we can accomplish. We have seen it right here in Cleveland with the evolution of views on land banks and demolition. I am confident we can see it in any number of future policy proposals.

In the meantime, let's join together to strengthen the financial capability of our citizens. The Federal Reserve is ready, willing, and able to partner with you. Thank you. I look forward to hearing your ideas and I hope you find the next two days informative and inspirational.

---

1. See "What's Really Happening in Housing Markets," Federal Reserve Bank of Cleveland Economic Commentary, July 2007.

2. See "Understanding Ohio's Land Bank Legislation," Federal Reserve Bank of Cleveland Policy Discussion Paper, January 2009, and "The Impact of Vacant, Tax-Delinquent Foreclosed Homes on Sales Prices of Neighboring Homes," Federal Reserve Bank of Cleveland Working Paper, March 2012.

3. The US Department of Housing and Urban Development.