

Elizabeth A Duke: Stabilizing the housing market – focus on communities

Speech by Ms Elizabeth A Duke, Member of the Board of Governors of the US Federal Reserve System, at the American Bankers Association National Conference for Community Bankers, Phoenix, Arizona, 16 February 2009.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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It is great to be back here with community bankers. The last time I addressed this conference, I was a community banker and also chairman of the American Bankers Association. I never dreamed that I would be back four years later as a member of the Board of Governors. Before I took office, I wrestled with the question of how I could contribute to the work of the Board and how difficult it might be to change from the perspective of a banker to the perspective of a public policy maker. So I asked a friend of mine, who had spent most of his career as an attorney before becoming an appellate court judge, just how he had made the transition from advocate to jurist. He told me that he found that he developed a different framework for decisionmaking, a different mindset, but one that was enriched by his experience and knowledge of the law. He said it happened quite naturally and predicted that I would experience the same thing. And he was right. So I thought I would begin by talking a little about how I approach my role at the Fed and then discuss the housing and mortgage markets, with particular emphasis on the impact this crisis is having on communities. I want to emphasize that any opinions I express here today are mine alone and do not represent the opinions of anyone else within the Federal Reserve System.

The Federal Open Market Committee (FOMC), as you all know, is responsible for overseeing open market operations, which is the principal tool of monetary policy. On a voting basis, it is composed of all of the members of the Board of Governors, the president of the Federal Reserve Bank of New York, and 4 of the 11 remaining Reserve Bank presidents, who vote on a rotating basis. While only five vote, all of the Reserve Bank presidents contribute equally to the discussion. My contributions to the discussion of current and projected financial and economic conditions are shaped largely by my conversations with bankers, my knowledge of bank management principles, and the Main Street perspective on the economy that I developed in my years as a banker working with consumers and small businesses.

In the six months that I have been at the Board, actions taken by bankers have had a tremendous influence on the economy. As part of preparing for FOMC meetings, I call a number of bankers at different size banks around the country to get their assessments of conditions in their banks and in their markets. My questions recently have focused primarily on the effect of government initiatives and on lending conditions. I also think through the actions that I might take as a banker if confronted by prevailing circumstances. For example, in evaluating the likely impact of the Treasury's recent Capital Purchase Program, I mentally walked through what would have been my own decision tree when trying to decide whether to apply for capital and, if I did receive capital, how I might use it.

In addition to the FOMC, I sit on the Board's Committee on Supervisory and Regulatory Affairs and chair the Committee on Consumer and Community Affairs. In these roles, I have been able to use my deeply ingrained knowledge of existing regulations, including their purposes and origins, as well as my familiarity with the examination process. And while I have long been an advocate for reducing regulatory burden, I have never questioned the need for strong regulation and supervision, only the efficiency of its implementation. So, now I have the opportunity to shape the implementation of new regulations and review existing ones, including those for safety and soundness as well as for consumer protection. But, as you know, regulations are only one part of the Federal Reserve's role in ensuring a sound

banking industry; those regulations must be complemented by strong supervision. That is, not only do we establish a set of rules for bankers to follow, but we also ensure that while abiding by those rules, the banking industry remains in an overall safe and sound condition.

In fulfilling my new role as a policymaker, I find that there are some basic beliefs that I held as a banker that continue to guide me.

- I believe that the banking business plays a special role in the economy and carries with it special responsibilities. These responsibilities come from the role of the financial system as the circulatory system of our economy. And with respect to insured depository institutions, given the federal safety net provided by deposit insurance, access to the payment system, and the availability of discount window borrowings, bankers have a responsibility to operate in a safe and sound manner.
- I believe that rigorous supervision and enforcement are necessary companions to regulation. One of the lessons we have learned in the current crisis is that different levels of supervision and enforcement can cause problems, even when institutions are ostensibly following the same regulations. Nowhere was this more evident than in the mortgage origination market, in which banking organizations and firms outside the banking supervision system were all originating mortgages but were subject to very different levels of oversight.
- I believe in the separation of banking and commerce. The lending policies of banks should have as their purpose the efficient channeling of savers' funds to their most productive uses. The allowance of banks to affiliate with commercial firms threatens the ability of banks to continue to serve as efficient and objective intermediaries of credit and has the potential to expose banks to the operational, financial, and reputational risks of commercial affiliates. It also has the potential to extend to commercial affiliates the federal safety net afforded to banks in recognition of their role in the economy.
- I believe that a bank holding company should act as a source of financial and managerial strength to its banking subsidiaries. That is, a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity, and it should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks. The reasoning behind these functions is that a bank holding company derives certain benefits at the corporate level that result, in part, from the ownership of an institution that has access to the federal safety net, including deposit insurance. This principle is, naturally, very familiar to almost all bankers, since it is embedded in Federal Reserve regulation, but it is worth repeating from time to time.
- Finally, I believe that strict adherence to consumer protection is necessary to protect consumers and the financial system as a whole. We have now witnessed the severe consequences of inadequate consumer understanding of financial products and of lending to consumers without regard to their ability to sustain the payments. Reasonable regulations, such as the Federal Reserve's recent rule changes for mortgages and credit cards, can help protect consumers and encourage responsible lending.

Much of my time is currently absorbed by activities related to this last point, as well as the broader housing and mortgage crisis. In addition to my Board committee assignments, I represent the Fed on the oversight board of the HOPE for Homeowners (H4H) program, an FHA program created by the Congress that allows lenders to refinance a delinquent borrower into an FHA-insured fixed-rate mortgage if the lender and borrower agree to certain conditions. Again representing the Fed, I also recently joined the board of directors of NeighborWorks America, a national, congressionally chartered nonprofit organization

focused on affordable housing and, in the face of growing needs, on responses to problems facing communities as a result of the housing and mortgage crisis.

Today I would like to share my thoughts about the problems in housing markets and mortgage lending, with a focus on how they affect communities. Every time someone talks of troubled mortgages on bank balance sheets, they are also talking about distressed homeowners, distressed neighborhoods and distressed communities. I've heard many of you say to me, "We didn't cause this problem. We didn't make any subprime mortgages. It's not fair that we should have to pay the price." I understand that many of you may be frustrated because you feel you have acted in a prudent manner while others have not. But additional parties are also suffering from the imprudent actions of others, such as the homeowners in your community who dutifully pay their mortgages but still see their houses fall sharply in value. More broadly, the recovery of the macroeconomy and the financial system are being inhibited by ongoing problems in the housing and mortgage markets. At this moment, we all simply need to do whatever we can to address the enormous challenges facing our communities, including those of us who believe we were being prudent and were not a cause of the difficulty in the first place. With that in mind, let me delve a bit more into the details of the current housing problems and offer some thoughts about what might be done to improve the situation.

The current weakness in housing markets

Housing activity remains extraordinarily weak. Sales of new and existing homes have been running at a pace that is 60 percent of that seen at the peak in 2005. Single-family housing starts are now less than one-quarter of their peak level. With the cutbacks in construction, inventories of unsold new homes have declined, but the months' supply – that is, inventories relative to sales – is still very high by historical standards. The inventory of existing homes for sale is also quite elevated – and it would be even higher if not for would-be sellers who have withheld or withdrawn their homes from the market amid poor selling conditions.

We have also seen sharp drops in home prices. When home prices were at their peak three years ago, most analysts agreed that housing valuations seemed to be substantially higher than warranted by fundamentals. However, home prices at the national level are now 18 percent off their peak, with some states, such as California and Florida, experiencing declines on the order of 40 percent.¹ These declines may have reversed much, or perhaps all, of the earlier overvaluation. That said, futures markets and many analysts foresee further declines. Expectations that house price declines have not yet reached their trough are probably deterring some prospective homeowners from making purchases and thereby contributing to the current weakness in housing demand.

A key factor inhibiting recovery is that the adverse conditions in the housing and mortgage markets have been, and continue to be, mutually reinforcing. As I am sure you are painfully aware, delinquencies on mortgages have risen sharply in recent years. By way of background, the problems began in the nonprime mortgage market. As house prices boomed in the middle part of this decade, mortgage originators relaxed underwriting standards and extended mortgages with low or no down payments to households with weak credit histories or those that did not fully document their income. Many of these loans had low initial interest rates that reset to market rates after a couple of years, which resulted in a significant increase in the monthly payment. Had house prices continued to rise, many borrowers would have been able to refinance to avoid higher payments and perhaps to extract accumulated home equity to use for future payments. However, the downturn in house prices meant that many borrowers did not have sufficient equity to refinance. Payment problems began to rise,

¹ Figures based on data from LoanPerformance, a division of First American CoreLogic.

which, in turn, led lenders to tighten standards and made it even more difficult for borrowers to obtain new loans, which put even more upward pressure on delinquencies. Eventually, investors became unwilling to fund higher-risk mortgages at any price.

Although the current problems appear to be rooted in high-risk subprime lending, I would like to dispel the notion that these problems were caused in any way by Community Reinvestment Act (CRA) lending. The CRA is designed to promote lending in low- to moderate-income areas; it is not designed to encourage high-risk lending or poor underwriting. Our analysis of the data finds no evidence, in fact, that CRA lending is in any way responsible for the current crisis. In our analysis of loan originations, we found that approximately 60 percent of higher-priced loans went to middle- or higher-income borrowers or neighborhoods, which are populations not targeted by the CRA. Additionally, more than 20 percent of the higher-priced loans that were extended in low- to moderate-income areas, or to low- to moderate-income borrowers, were loans originated by lenders not covered by the CRA. In fact, the analysis found that only 6 percent of all higher-priced loans were made by CRA-covered lenders to borrowers and neighborhoods targeted by the CRA. This very small share makes it hard to imagine how CRA could have caused, or even contributed in a meaningful way, to the current crisis. Further support for this conclusion comes from our finding that serious delinquency rates for subprime loans are high in all neighborhood-income categories, not only those in lower-income areas, as might be thought if the CRA were a contributing force to the subprime crisis.²

The problems in the high-risk mortgage market, together with the more general pullback in risk-taking across virtually all financial assets, reduced the willingness of lenders to fund all types of mortgages. We are now seeing widespread payment problems in every category of mortgages. To be sure, the deterioration partly reflects households straining to meet their mortgage obligations amid the broader weakening of macroeconomic conditions. However, it also reflects the fact that reduced home equity and tighter mortgage credit have impaired borrowers' ability to refinance their mortgages in order to cope with income loss, unexpected expenses, or adverse life events.

According to the latest data, 25 percent of subprime loans and 13 percent of near-prime loans are now seriously delinquent – that is, more than 90 days past due or in foreclosure. The serious delinquency rate for prime mortgages, at between 3 percent and 4 percent, is much lower than for nonprime loans, but it has doubled over the past year. Foreclosures have also risen sharply. The available data suggests that lenders initiated 2-1/4 million foreclosures last year, more than twice the number seen in 2006.³ In the past, about one-half of foreclosures initiated were cured through a repayment plan or some other arrangement, but the remaining one-half resulted in the loss of a home. The share resulting in home loss could well be higher now given the large numbers of distressed households and the bleak underlying economic conditions.

Addressing the problems in housing and mortgage markets

Several considerations underscore the need for policymakers to take further actions to address the current problems in the housing and mortgage sectors. To begin, the weakness in the housing sector remains a significant drag on the macroeconomy and is reinforcing the strains in the financial system. Moreover, the wave of foreclosures has the potential to

² See Glenn Canner and Neil Bhutta (2008), "Staff Analysis of the Relationship between the CRA and the Subprime Crisis," memorandum, Board of Governors of the Federal Reserve System, November 21.

³ Estimates of subprime and near-prime delinquency rates are for loans in securitized pools, based on data from LoanPerformance, a division of First American CoreLogic. Estimates of prime delinquency rates are based on data from McDash. Estimates of foreclosures initiated are based on data from the Mortgage Bankers' Association.

exacerbate the problems going forward. In past housing cycles, house prices have tended to fall below the level warranted by fundamentals, presumably as weak market conditions led sellers to make aggressive price cuts. The potential for an overcorrection of house prices in this cycle seems particularly acute given the potential for foreclosures to create a glut of properties for sale. A high level of foreclosures results in lower prices, and lower prices tend to accelerate the pace of foreclosures. And, of course, further large declines in house prices would accentuate the broader problems in the macroeconomy and financial system through the channels that I just discussed.

Foreclosures also cause significant distress among the families that lose their homes. Whether the foreclosure is the result of inadequate underwriting by the mortgage lender, irresponsibility on the part of the homeowner, or uncontrollable life events such as job loss, the result is the same: Displaced families with depleted resources and impaired credit have difficulty finding a new place to live. They may have to move significant distances, which may affect their ability to retain their jobs and disrupt other aspects of their lives as well as the lives of their family members. In addition, one in five foreclosures appears to be affecting renter-occupied units. The families in these units may also be displaced, even if they are paying their rent on time and abiding by the terms of their lease agreement.

Such disruptions, apart from creating personal and emotional strains, can also have detrimental economic effects. Large numbers of displaced families will further strain inadequate supplies of rental housing that are affordable to low- and moderate-income families. Although the overall supply of rental housing has been slowly expanding in recent years, new units have largely been built for the higher end of the market, with median asking rents being 38 percent higher than average, while more-affordable units have been demolished or permanently removed from the inventory.⁴ In the current environment, this lack of new production has been exacerbated by the restricted availability of financing for multifamily housing, reduced support by government-sponsored enterprises for multifamily housing, and lower utilization of the Low Income Housing Tax Credit program.

In areas where foreclosures are concentrated, communities will suffer. Clusters of vacant properties can foster crime, such as vandalism and arson, and studies have shown that they lead to lower house prices throughout the neighborhood.⁵ Municipal governments may have to spend more on maintaining properties and preventing crime just when resources are stretched thin, in part because of the reduced tax revenue associated with lower house prices. Such spending may well crowd out the provision of other types of public services.

Fiscal and monetary stimulus directed at improving employment conditions and federal support for housing finance will ultimately strengthen the housing market. However, we also need measures that directly address the foreclosure problem associated with the current crisis. In designing such measures, we must consider that there are different types of borrowers. First, there are distressed borrowers who can avoid foreclosure through an appropriate modification of their loan. Second, there are some borrowers who, due to resources or circumstance, will be unable or unwilling to sustain their mortgage payments even with reasonable loan adjustments from the lender or support from government programs. In such cases, foreclosures will happen, and we need to limit both the direct costs to the lender and the borrower as well as the broader social costs. Of course, there is a third group of borrowers – those who are still successfully meeting their mortgage obligations.

⁴ Harvard University, Joint Center for Housing Studies (2008), "America's Rental Housing: The Key to a Balanced National Policy".

⁵ See, for example, William C. Apgar, Mark Duda, and Rochelle Nawrocki Gorey (2005), "The Municipal Cost of Foreclosures: A Chicago Case Study," Housing Finance Policy Research Paper 2005-1 (Minneapolis, Minn.: Homeownership Preservation Foundation, February); and John P. Harding, Eric Rosenblatt, and Vincent W. Yao (2008), "The Contagion Effect of Foreclosed Properties," Social Science Research Network working paper 1160354 (New York: SSRN, July).

One might be tempted to view these households as a lesser concern, but we must be mindful that they will be more likely to shift into one of the distressed groups if we do not reduce both the number of foreclosures and the cost of the foreclosures that do occur.

Reducing preventable foreclosures

To help those distressed households for which foreclosure can be prevented, servicers must implement effective and sustainable modifications. Key private and public steps toward preventing unnecessary foreclosures have already been taken, but much more must be done. While community bankers typically do not have large portfolios on which to perform wholesale modifications, I would urge you to be sure that you are making reasonable accommodations whenever possible to keep homeowners in their homes.

While speed and volume in modifications are important, in my view, it is equally essential that the new obligations be sustainable in the long run. By "sustainable" I mean that the payment should be fixed for the life of the loan, it should be affordable, and it should be based upon verified income. In changing the terms of the mortgage, servicers may start with changing the interest rate or adjusting the maturity to make the payments more affordable, but they also need to consider whether writing down loan principal amounts make sense. Doing the latter may be more effective at reducing the probability of redefault.⁶ These design principles for modifications are all included in the Homeownership Preservation Policy recently adopted by the Federal Reserve Board.⁷ The Federal Reserve announced that it would apply this policy to the residential mortgage assets held by the special purpose vehicles established by the Federal Reserve to facilitate the acquisition of Bear Stearns by JPMorgan Chase and to assist the American International Group, Inc.

Reducing the costs when foreclosures cannot be prevented

Without in any way minimizing the need for continued emphasis on foreclosure prevention, I don't believe we can fully formulate appropriate policy responses to the crisis unless we acknowledge and address the large numbers of foreclosures that are not avoidable. We are likely only beginning to see the serious costs of the foreclosures that have already been initiated, both because of the often-substantial amount of time required to complete a foreclosure and because the costs likely compound as the number of foreclosures grows larger. Moreover, even under optimistic assumptions for the number of loan modifications and other forms of private and public assistance that may be realized, the pace at which foreclosures are initiated is likely to remain extremely elevated for some time. Just as public focus, experimentation, and policy debate have informed best practices with regard to loan modifications, we must also begin the work of developing responsible protocols for the management of foreclosures and real estate inventory. Minimizing the amount of time that properties remain vacant and maximizing the price at which they are sold will serve the

⁶ The available evidence, though not conclusive, suggests that the homeowner's equity position is, along with affordability, an important determinant of default rates, for owner-occupiers as well as investors. See Shane Sherlund (2008), "The Past, Present, and Future of Subprime Mortgages," Finance and Economics Discussion Series 2008-63 (Washington: Board of Governors of the Federal Reserve System, November); Kristopher Gerardi, Christopher L. Foote, and Paul S. Willen (2008), "Negative Equity and Foreclosure: Theory and Evidence," Public Policy Discussion Papers 08-3 (Boston: Federal Reserve Bank of Boston, June); and Andrew Haughwout, Richard Peach, and Joseph Tracy (forthcoming), "Juvenile Delinquent Mortgages: Bad Credit or Bad Economy?" *Journal of Urban Economics*.

⁷ See Board of Governors of the Federal Reserve System (2009), "Board Announces Policy to Help Avoid Preventable Foreclosures on Certain Residential Mortgage Assets Held, Owned, or Controlled by a Federal Reserve Bank," press release, January 30; and Board of Governors (2009), "Homeownership Preservation Policy for Residential Mortgage Assets," Board policy, January 30.

interests of both lenders and the communities. During the time properties do remain vacant, servicers have a responsibility to follow local codes and ensure that the properties are secured and maintained. At this moment, lenders and communities alike are woefully under-resourced and unprepared for the volume of real estate that will need to be processed.

Some attention has already been focused on getting renters or owners into real estate owned (REO) and vacant properties and thus off of servicers' books – something that is in the shared interest of servicers, investors, and communities, particularly as the inventories of these types of properties mount. At the national level, there is some movement to enable state and local governments, as well as nonprofits, to purchase properties from servicers' REO inventories where sales are otherwise stagnant. Such efforts are challenging in many areas because of a lack of financial resources and experience in the kinds of activities that are required. Some help will be provided through the Housing and Economic Recovery Act of 2008, in which the Congress set aside \$3.92 billion to assist state and local governments with REO purchases and related efforts. The Department of Housing and Urban Development created the Neighborhood Stabilization Program (NSP) to distribute these funds.

Many servicers are stepping up their efforts to sell their large and growing inventories of REO properties, although setting an appropriate price in the current environment remains difficult. To facilitate REO sales, the National Community Stabilization Trust (NCST), a new entity formed by four national nonprofit intermediaries, is trying to create a common platform for servicers to efficiently sell REO properties to public entities and nonprofit organizations. Some REO owners, such as Fannie Mae, are also creating dedicated sales channels to sell REO properties to public entities and nonprofits, either through the NCST or through discounted bulk sales. And some local governments are crafting comprehensive approaches using the NSP funds to bring in private- and public-sector entities to manage and sell REO inventories.

The Federal Reserve has also taken steps to help address the costs of foreclosures on communities. The Community Affairs offices of the Board of Governors and all 12 Reserve Banks held a series of forums in 2008, entitled "Recovery, Renewal, Rebuilding," that explored the problems and highlighted promising solutions. We have also partnered with NeighborWorks America to support its efforts to help community leaders grappling with these issues; that effort has led to the creation of new tools, training, and the spread of information.

But current efforts are not sufficient to deal with the scale and scope of the problem, and more needs to be done. State and local governments and nonprofits are working hard but often lack the capacity and scale to address the magnitude of the REO disposition problem. More dollars alone will not solve this problem. State and local governments need to do more to partner with private-sector entities that have experience managing scattered-site housing inventories, including rental housing. In addition, we need to make sure that we are using all of the available public-sector capacity – such as state housing finance agencies and local public housing authorities – that have experience managing affordable rental housing inventories. Finally, we need to do more to explore creative solutions to speed the acquisition of REO properties so that they do not languish vacant.

Given the likely number of properties that will enter foreclosure and the time and resources involved in the foreclosure process, financial institutions can help minimize the cost by developing clear policies and procedures for approval of short sales and deeds-in-lieu-of-foreclosure. For homeowners who cannot, or no longer wish to, stay in their homes, such strategies release them from their obligation and avoid foreclosure. Some institutions already offer a so-called fresh start or cash-for-keys program, in which they provide a small payment to consumers in exchange for voluntarily surrendering the deed to the home. Such arrangements reduce the cost of foreclosure and provide consumers with relocation assistance. Other lenders are offering borrowers the option to remain in their home as renters rather than owners. More lenders should consider these options, perhaps in

conjunction with loan modification programs, as further inducement for borrowers to engage in discussions about loan resolution. At the same time, governments might develop policies to accelerate foreclosure in cases where the property has been vacated and the lender has agreed to secure and maintain the property.

If renters occupy the property, servicers of REO properties should extend existing lease arrangements whenever possible and while tenants are abiding by the terms of their lease. Some REO owners, including Fannie Mae and Freddie Mac, are already taking steps to minimize the disruption and displacement to renters living in foreclosed-upon properties. If a property is likely to sit vacant for long periods of time and create problems for the surrounding area, servicers might consider sale of REO properties to, or partnerships with, responsible third parties, including local governments and nonprofit groups.

Financial institutions should look for ways to partner with community groups and governments to support strategies to stabilize communities affected by foreclosure. They can bring invaluable technical capacity to plan and execute stabilization efforts. Banks can also support efforts to reuse REO properties by providing home loans to new homebuyers and by financing nonprofit entities and others for the acquisition and rehabilitation of REO properties. In addition, they can help victims of foreclosure to rebuild their credit histories and thereby facilitate their re-entry into the economic mainstream.

Finally, regulators should consider whether existing regulations regarding real estate held for extended periods of time on bank balance sheets act as an obstacle to creative solutions to the foreclosure problem.

Conclusion

In summary, broad policy measures are a central ingredient to restoring the health of the U.S. economy and global financial system. However, as I have discussed today, there is also a pressing need for more targeted policy measures that specifically address the current problems in the housing sector. We need considerable public support for housing finance until private credit and securitization markets are restarted. We need to strengthen and augment our efforts to reduce preventable foreclosures. In addition, we need to turn far greater attention to limiting the costs of foreclosures that do occur. Such efforts are not only in the interest of the families who are directly affected and their immediate communities, but are also in the interest of the financial institutions involved and the broader economy. Because much of the cost does not occur as soon as a foreclosure has been initiated and can grow with time, we must be forward-looking and affirmatively engage in efforts to mitigate the consequences now.

As community bankers, you have a long history of engagement in your communities. You have served on the boards of public and nonprofit entities focused on housing. You have built Habitat for Humanity houses, and you have rebuilt entire neighborhoods following natural disasters. Your financial resources will be needed as we work toward solutions for the current crisis, but, even more important, your experience, expertise, contacts, and creativity will be needed. If you believe in the saying that "all real estate markets are local," you also understand that it will take local knowledge to assess community needs and craft solutions. If you are not quite sure where to start, contact your local housing nonprofit or Federal Reserve Bank. Contact municipal authorities or housing counselors. Partner with other banks in your market or do it alone. But do it today. As always, your communities depend on you.