

## **Elizabeth A Duke: Prescriptions for housing recovery**

Speech by Ms Elizabeth A Duke, Member of the Board of Governors of the Federal Reserve System, at the National Association of Realtors Midyear Legislative Meetings and Trade Expo, Washington DC, 15 May 2012.

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Good morning. The title of this session is “Prescriptions for Housing Recovery.” I wish I had such a prescription. Problems related to mortgage debt and mortgage underwriting played a central role in the recent financial crisis and resulted in a massive dislocation in the housing market. It is difficult to think of a single prescription that by itself will generate a sustainable recovery in housing. At the same time, I do see policies that I believe will help reduce the shadow inventory of houses in the foreclosure pipeline. I also see policy actions that could be taken to improve credit availability for potential homebuyers and, in turn, demand for houses. I have talked at length in previous speeches about actions that I believe would help alleviate the effects of excess foreclosure inventory on the housing market.<sup>1</sup> In my remarks today I will mention those possible actions only briefly and then focus primarily on policy issues that I expect will shape the availability of credit for home purchases in the future.

Before I begin my remarks, I want to emphasize that the views that I will present today are my own and not necessarily those of my colleagues on the Federal Open Market Committee (FOMC) or the Board of Governors.

### **State of housing markets**

Let me start with a review of the fallout from the boom and subsequent bust in housing. It was only six years ago that the housing market was booming: The homeownership rate stood at 69 percent, and aggregate housing wealth reached nearly \$23 trillion. Since then, however, the housing market has struggled, to say the least: The homeownership rate has declined to 66 percent, and national house prices have fallen about one-third, while house prices in hard-hit areas, such as Las Vegas, have fallen almost twice that amount. As a result, nearly \$7 trillion in housing wealth has been lost.

### **Housing supply**

House prices have been weighed down by the large proportion of distressed sales – that is, sales resulting from foreclosures or short sales – and the specter of the large shadow inventory currently in the foreclosure pipeline. High levels of unemployment, weak income growth, and negative equity have contributed to a staggering 2.2 million loans in the foreclosure process and another 1.7 million loans that are three or more payments behind. Moreover, due to ongoing delays in the foreclosure process, more than 40 percent of loans in foreclosure are more than two years delinquent.

While these statistics are indicative of a historic level of homeowner stress, they are down from their post-crisis peaks, and there are signs that further gradual improvement may lie ahead. The share of loans entering delinquency for the first time has been trending lower for

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<sup>1</sup> For example, see Elizabeth A. Duke (2012), “Economic Developments, Risks to the Outlook, and Housing Market Policies,” speech delivered at “2012 Financial Forecast,” an event sponsored by the Virginia Bankers Association and the Virginia Chamber of Commerce, held in Richmond, Va., January 6; and Elizabeth A. Duke (2011), “Rebalancing the Housing Market,” speech delivered at “The Housing Market Going Forward: Lessons Learned from the Recent Crisis,” a policy forum sponsored by the Board of Governors of the Federal Reserve System, September 1.

more than two years. This decline in early-stage delinquencies has coincided with sustained reductions in broader measures of delinquency – most notably, total loans past due. These favorable trends likely reflect somewhat better economic conditions. But efforts to resolve troubled mortgages through loan modification, short sales, and deeds-in-lieu of foreclosure should also be credited. Further, mortgages that were originated using the tight underwriting that has prevailed since 2008 would presumably have lower delinquency rates, and recent vintage loans now make up an increasing share of outstanding mortgages.

There are some promising signs in the trend of house prices as well. Although house prices have continued to fall year-over-year, the pace of decline has slowed notably and the month-over-month readings have shown increases for three months now. National house prices fell less than 1 percent for the year ending in March. With the exception of the period around the 2010 first-time homebuyer tax credit, this year-over-year decline was the smallest since early 2007. Moreover, according to CoreLogic data, home prices have risen in more cities lately than they have fallen. Indeed, over 45 percent of cities saw their home prices rise more than 1 percent in the past three months, the most since early 2006.

These modest improvements in house prices can only be sustained if the demand for homes strengthens or the supply of homes for sale falls to meet weak demand. My Realtor friends have taught me that when inventories of houses for sale reach a level equal to six months of sales, then markets are usually in rough balance, meaning that levels below six months tend to favor sellers and those above six months favor buyers. My economist colleagues talk about much the same concept – using, as they so often do, a vocabulary that may not be familiar to others. In particular, they think about the idea of equilibrium prevailing in a market, so that prices are roughly stable. And, indeed, just as the inventory of existing homes for sale nationally has approached six months of sales, we have seen a leveling of prices suggesting that some equilibrium is being achieved, albeit at low levels. Of course, as Realtors know very well, these national data mask some significant differences in individual markets. Inventory in some markets is reportedly quite tight, including some markets such as Miami and Phoenix where the level of past due loans and loans in the process of foreclosure is still quite high. For me, this calls into question the notion that housing prices cannot stabilize until the foreclosure pipeline is worked off. I believe that this reduction in inventory, even in the face of a steady supply of foreclosed homes, is a result of a sharp contraction in normal homeowner activity and an equally sharp expansion of investor activity. Certainly, as prices fell, many existing homeowners withdrew their homes from the market either because they were unwilling to sell at low prices or because they were unable to sell if they could not receive enough money from the sale to pay off their mortgages.

At the same time, a significant portion of the inventory has been absorbed by investors attracted by low prices and increasing rental rates. So far, the investors purchasing single-family properties have been primarily small investors who have had difficulties obtaining financing to purchase more than a handful of properties. Recently, however, anecdotes have been proliferating about investors establishing entities to purchase and manage a larger number of properties – on the order of several hundred to several thousand of them. In addition, pilot programs are currently under way to solicit larger-scale investor interest in properties owned by Fannie Mae and Freddie Mac. If successful, these programs could act to simultaneously reduce the number of distressed sales and meet the elevated demand for rental housing.

Recent indicators of housing construction activity have also been somewhat encouraging. Housing starts and permits have edged up from very low levels, and builders' and Realtors' ratings of housing market conditions have stepped up a fair bit. In addition, multifamily starts have risen steadily, likely in response to higher apartment demand and falling vacancy rates.

## **Demand for housing**

Notwithstanding these signs of improvement in the housing market, demand for owner-occupied housing remains stubbornly tepid. An important driver of housing demand is household formation. Although household formation typically falls during economic downturns, it has been especially weak this time around. Since 2007, household formation has been running at three-fourths of its normal rate of about 1 million households per year. In addition, many potential homebuyers are delaying home purchases because they are worried about their income or employment prospects. Others look at declining house prices and either conclude that they can wait and buy at a lower price or fear that if they do buy, they might lose their home equity. Even so, the drag of these factors on housing demand should begin to wane as the gradual recovery in the labor market progresses and house prices stabilize.

Unfortunately, some buyers who would like to purchase a home are unable to do so because they are unable to obtain a mortgage. According to the Federal Reserve's quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS), underwriting standards for residential mortgages tightened steadily from 2007 to 2009, and they do not appear to have eased much since then.<sup>2</sup>

This tightening of credit standards is apparent in the credit scores of borrowers who obtain mortgages. For newly originated mortgages, the median credit score of prime borrowers rose from about 700 in 2006 to more than 760 in 2009, where it remains today. Moreover, a large swath of borrowers who likely had access to credit a few years ago appear to be essentially excluded from the mortgage market under current prevailing standards. Indeed, in an indication of the minimum credit score required to obtain credit, the credit scores of borrowers in the bottom 10 percent of those who obtained credit have risen from around 625 in 2006 to approximately 690 today.

Tight mortgage underwriting standards make obtaining mortgage credit particularly more difficult for first-time homebuyers. Because first-time homebuyers tend to be younger than other homebuyers, they also tend to have lower credit scores and fewer financial assets that can be used for down payments. As a result, tight lending standards would be expected to constrain their demand by more than it would for other homebuyers. Indeed, research by Federal Reserve staff finds that first-time homebuying during the past two years has been quite weak by historical standards, and that this weakness has been particularly pronounced among borrowers with lower credit scores.

## **Understanding tight mortgage credit conditions**

So why is access to mortgage credit so tight? Lenders may have tightened credit standards partly as a correction for the lax and problematic lending standards that prevailed in the years leading up to the peak in house prices. And, given the significant consequences that those lax lending standards had for many households, communities, financial institutions, and the economy, some tightening of credit standards is warranted. But it seems likely that other factors are at work as well.

Constraints on lenders' capacity to process loan applications have reportedly been part of the story. Since the crisis hit, some lenders have closed their doors, and others have cut back substantially on staff. In addition, a shift to full documentation of income and assets, along with a heightened concern that underwriting mistakes could cause lenders to be forced to repurchase seriously delinquent loans, has lengthened the time required to originate each mortgage. Indeed, according to Home Mortgage Disclosure Act data, the median time that

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<sup>2</sup> The SLOOS is available on the Board's website.

elapsed between mortgage application and closing increased from about 4 weeks in 2008 to around 6 weeks in 2010. Moreover, empirical evidence suggests that lenders might be nearly as capacity-constrained now as during the 2003 refinance boom, even though current mortgage volume is only about one-third of the volume in 2003. But capacity constraints alone are an unsatisfying answer to the question of why access to credit is so tight. It seems reasonable to suppose that if lenders were eager to originate mortgages, they would have an incentive to invest in staff and systems to alleviate these constraints. I believe uncertainty about the future on the part of lenders is inhibiting these investments.

### **The problem of uncertainty**

Just as uncertainty about job prospects or house prices has likely discouraged some potential buyers from purchasing homes, it is likely that uncertainty has also affected mortgage lenders. Indeed, uncertainty surrounds several key aspects of mortgage lending: the strength of the economic recovery and the trajectory of future house prices; the costs and liabilities associated with originating and servicing mortgage loans; the regulatory environment; and the future structure of the mortgage market, including that of Fannie Mae and Freddie Mac and of private-label securitization. I think the effects of these uncertainties have an important bearing on the future strength of the housing market and would like to discuss each in a bit more detail.

Turning first to macroeconomic uncertainty, borrowers are more likely to default when they lose their jobs or when their houses decline in value. So long as unemployment remains elevated and further house price declines remain possible, lenders will be cautious in setting their requirements for credit, and rightfully so. But these factors should ease as the economic recovery gains steam and the trajectory for house prices appears more certain.

Although house price declines have moderated notably, the continuing effects on house prices of the large number of underwater mortgages and of the mortgages still in the foreclosure pipeline remain unclear. Even professional forecasters diverge widely in their views about the future path of house prices: In one recent survey, house price forecasts for 2012 ranged from a decline of 8 percent to an increase of 5 percent.

Uncertainty about house prices and the high volume of distressed sales make the job of residential appraisers and lenders more difficult. In the current market, appraisers may tend to have a more conservative view of a home's market value and, as long as house prices continue to decline, lenders may lean toward more conservative underwriting. Taken together, these factors could discourage or even disrupt sales that might otherwise happen smoothly. Like you, we have been hearing such reports.

While macroeconomic uncertainty is likely an important contributing factor to tight mortgage credit conditions, we also observe that lenders have tended to be conservative in making some mortgages that are guaranteed by government-sponsored enterprises (GSEs) – loans in which lenders do not bear the credit risk in the event of borrower default – which suggests that issues other than macroeconomic risk are affecting lending decisions. Indeed, analysis by Federal Reserve staff suggests that only about half of lenders currently offer mortgages to borrowers whose credit metrics fall into the lower range of GSE purchase parameters.

In the April SLOOS, lenders were asked targeted questions about the likelihood, compared with 2006, that they would originate mortgages with specific credit profiles. Responses confirmed that lenders today are less likely – and often much less likely – to originate loans to GSE borrowers with credit scores of 620 even when borrowers were making down payments of 20 percent. In fact, the only category of borrower to have experienced no net reduction in reported credit availability was the category with the highest credit profile asked about in the survey – those with down payments of 20 percent and credit scores of 720.

Lenders who responded in the April SLOOS that they were less likely to originate loans were asked to identify the reasons why. About 80 percent of the respondents reported greater

borrower difficulty in obtaining affordable private mortgage insurance, a less favorable economic outlook, or the outlook for home prices as being at least somewhat important. But policy concerns played a role as well. In an indication that delinquency risk is now considered in addition to the risk of credit loss, more than half the respondents cited risks associated with loans becoming delinquent as being at least somewhat important – in particular, higher servicing costs of past due loans or the risk that GSEs would require banks to repurchase delinquent loans (known as putback risk).

The ability of the GSEs to put back loans when lenders have misrepresented their riskiness helps protect taxpayers from losses; however, if lenders perceive that minor errors can result in significant losses from putback loans, they may respond by being more conservative in originating those loans. In its recently released strategic plan, the Federal Housing Finance Agency (FHFA), the regulator of Fannie Mae and Freddie Mac, has identified the use of standardized data as a strategy for improving risk management for the GSEs while reducing repurchase risk for lenders. If technology and data standardization can be used to enhance quality control reviews at the time of purchase rather than after the loans became delinquent, it would allow errors to be corrected much earlier, and thus should result in better outcomes for taxpayers, borrowers, investors, and lenders. Judging from the responses to the April SLOOS, I would expect any effort to clarify or reduce putback liability to have a corresponding effect on the standards for underwriting GSE loans.

Reluctance to make loans because of the higher cost of servicing delinquent loans could stem from uncertainty about future standards for delinquency servicing. Some of this uncertainty has been resolved by the state attorneys' general settlement with the 5 largest servicers and the consent orders that 14 large servicers have entered into with federal regulators. However, only about two-thirds of mortgages are covered by the terms of the settlement or are subject to consent orders.

To be sure, a number of efforts are under way to establish additional mortgage servicing standards. The Consumer Financial Protection Bureau (CFPB) has recently declared its intent to propose servicing rules that would apply to all mortgage loans. The FHFA strategic plan includes an initiative already in motion to create a single set of servicing protocols for both Fannie and Freddie loans. These new standards are being developed in consultation with federal financial regulators who are also exploring establishing uniform servicing standards for the institutions they supervise. However, while we hope that the prospect of uniform national servicing standards will lead to more consistent, efficient, and fair servicing practices, it is also generating uncertainty about the future costs of servicing mortgages and may be a factor in decisions by servicers to delay or abandon investments in servicing capacity.

Also affecting decisions about investing in servicing are new approaches to servicer compensation under consideration by the FHFA. Servicers currently receive the same compensation for loans that are up to date as they do for loans that are past due. Servicing fees significantly exceed the cost of the administrative tasks associated with loans that pay on time, but there is an expectation that servicers will stockpile some of this "excess profit" to cover the cost of servicing delinquent loans. The problems associated with loan modifications and foreclosures clearly demonstrate that servicers failed to invest enough in their infrastructure to be able to handle the current level of delinquent loans. Furthermore, this arrangement provides no incentive for servicers to take on loans that have a higher risk of going past due and incurring higher servicing costs. With origination and servicing closely linked, this incentive results in less credit offered to borrowers who have weaker credit profiles.

Moreover, servicers subject to regulatory capital requirements are likely to be affected by new international capital standards that change the capital treatment of the asset known as "mortgage servicing rights" that is created from servicing compensation. These new standards are expected to cap the amount of mortgage servicing rights that institutions can

include in regulatory capital, which could lead institutions to seek to limit or reduce the amount of mortgage servicing rights they own. This circumstance, in turn, could reduce the liquidity in the market for mortgage servicing rights and potentially drive their valuations down. Thus, the final design of servicer compensation along with servicing requirements will factor into the capital allocated to the mortgage business generally and to the relative tightness of credit standards.

Additional regulatory uncertainty arises from the Dodd-Frank Act requirement for two important regulatory rulemakings that could significantly influence mortgage underwriting as well as the cost and availability of mortgage credit. First, the CFPB is required to issue rules that will set requirements for establishing a borrower's ability to repay a mortgage. These rules would include a definition of a "qualified mortgage" or QM. Mortgages that meet the definition would be presumed to meet the standards regarding the ability of the borrower to repay. These rules are important because violation of the standards could subject lenders to penalties and, in some cases, impede their ability to collect on defaulted mortgages. In the second rulemaking, several regulators, including the Federal Reserve, are charged with establishing a definition for "qualified residential mortgages," or QRMs, a subset of QM that would be exempt from risk retention requirements in mortgage loan securitizations.

Without commenting on the specifics of any of these individual regulatory rules under consideration, I think it is important to note that potentially each of them – servicing requirements, capital requirements, and underwriting requirements – will affect the costs and liabilities associated with mortgage lending and thus the attractiveness of the mortgage lending business. The Federal Reserve is aware of this situation and will apply its best judgment to weigh the cost and availability of credit against consumer protection, investor clarity, and financial stability as it writes rules that are consistent with the statutory provisions that require those rules. But regardless of what the final contours of the rules are, I think the mortgage market will benefit from having them decided so that business models can be set and investments calibrated.

Other uncertainties are hindering the development of a new mortgage market structure, including the future role of the government in the mortgage market. Foremost among these issues is the uncertainty surrounding the future of Fannie Mae and Freddie Mac. Nearly three and a half years after the GSEs entered conservatorship, policymakers have reached no consensus about the future structure of the GSEs and the role the government should play in the mortgage market. Private capital might be reluctant to enter the market until the future parameters of government support are resolved.

Collectively, these uncertainties about the future are likely contributing significantly to the tight lending standards in the mortgage market today. Given the role that poor lending decisions played in the financial crisis, it is appropriate that lenders have tightened their lending standards. That said, if lenders tighten more than is warranted, it will hamper the recovery of the housing market and, in doing so, restrain economic growth. Moreover, the responses of lenders to these uncertainties may also have longer-term implications. If lenders are delaying needed developments in their own infrastructure, such as servicing systems and capacity, until they have more clarity about what the mortgage market will look like down the road, the resulting lack of infrastructure might constrain mortgage and housing markets in both the short term and the long term.

### **Choosing a path forward**

I have talked quite a bit about the factors that I believe are inhibiting a recovery in housing markets and some potential solutions to the problems I identified. We have had a severe financial crisis with housing and housing finance playing a central role, and recovery is not likely to be quick or easy. But I do believe there are some things that can help. So, if I were to write a prescription for housing recovery, I would include the following items.

Most important to the health of the housing market is the strength of the economic recovery – the labor market in particular. Potential homeowners are unwilling to buy if they are uncertain about their income prospects. And credit standards will remain tight as long as lenders are concerned about borrowers' ability to repay. For its part, the Federal Reserve remains committed to fostering maximum employment consistent with price stability, which should help reduce some of the macroeconomic uncertainty.

In addition, I think efforts under way to reduce the flow of foreclosed homes and distressed sales in the market will help to stabilize home prices. Mortgage loan modifications, short sales, and deeds-in-lieu of foreclosure all act to reduce the number of homes in the foreclosure pipeline. Recent price signals – higher rental rates and falling rental vacancies combined with low home prices and elevated single-family home vacancies – indicate that by reallocating some of the foreclosed home inventory to rental property, investors could help balance supply and demand in both the rental and the owner-occupied markets. Neighborhood stabilization efforts can help alleviate some of the costs to neighborhoods of foreclosure and allow local decisions regarding low-value and dilapidated properties. Many borrowers are current on their payments but are still unable to refinance to take advantage of low interest rates. Recent changes to the Home Affordable Refinance Program, or HARP, will allow more of these borrowers to refinance and lower their payments, thus reducing the likelihood that they will become delinquent.

But perhaps the most important solution that I am suggesting today is that policymakers move forward with the difficult decisions that will affect the future of the mortgage market. To be sure, important issues need to be addressed and hard questions remain to be answered. It will not be easy to decide what to do about the GSEs, or how best to promote a robust secondary market, or what form crucial regulations should ultimately take. And it is unlikely that anyone will fully agree with the final decisions that are made. Nevertheless, until these tough decisions are made, uncertainties will continue to hinder access to credit, the evolution of the mortgage finance system, and the ultimate recovery in the housing market. I don't want to diminish the importance of any individual policy decision, but I do believe that the most important prescription for the housing market is for these decisions to be made and the path for the future of housing finance to be set. It's time to start choosing that path.