

Ben S Bernanke: Fostering sustainable homeownership

Speech of Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the National Community Reinvestment Coalition Annual Meeting, Washington DC, 14 March 2008.

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This audience, the National Community Reinvestment Coalition, is certainly aware that mortgage delinquency and foreclosure rates have increased substantially over the past year and a half. This increase reflects significantly, though not exclusively, a sharp deterioration in the performance of subprime mortgages, particularly those with adjustable-rate features. At the end of last year, more than one in five of the roughly 3.6 million outstanding subprime adjustable-rate mortgages (ARMs) were seriously delinquent, meaning they were either in foreclosure or ninety days or more past due.¹ That rate is about four times higher than it was in mid-2005. Lenders initiated roughly 1-1/2 million foreclosures last year, up from an average of 950,000 in the preceding two years. More than one-half of the foreclosure starts in 2007 were on subprime mortgages. Behind these disturbing statistics are families facing personal and financial hardship and neighborhoods that may be destabilized by clusters of foreclosures. These realities challenge us to find ways to prevent unnecessary foreclosures. And, looking toward the future, they challenge us to ensure a regulatory environment that promotes responsible lending and sustainable homeownership.

I would like to briefly discuss how we arrived at where we are today. Then I would like to share with you what the Federal Reserve is doing to reduce foreclosures, to protect aspiring homeowners from unfair and deceptive practices, and to equip them to choose wisely from among the often confusing array of mortgage options. In particular, I would like to highlight the new regulations we have proposed under the Home Ownership and Equity Protection Act (HOEPA).

Origins of the subprime mortgage turmoil

Over the past quarter century, advances in information technology, the development of credit-scoring techniques, and the emergence of a large secondary market, among other factors, have significantly increased access to mortgage credit. From 1994 to 2006, subprime lending increased from an estimated \$35 billion, or 4.5 percent of all one-to-four family mortgage originations, to \$600 billion, or 20 percent of originations (Inside Mortgage Finance, 2007). Responsible subprime lending expanded credit to borrowers with imperfect or limited credit histories. More renters became homeowners than would have otherwise. Though few subprime mortgages are being written today, I believe responsible subprime lending has been helpful, and at some point will be again, in fostering sustainable homeownership.

However, far too much of the lending in recent years was neither responsible nor prudent. The terms of some subprime mortgages permitted homebuyers and investors to purchase properties beyond their means, often with little or no equity. In addition, abusive, unfair, or deceptive lending practices led some borrowers into mortgages that they would not have chosen knowingly.

¹ Based on servicer data from First American LoanPerformance.

The current crisis has many roots. The drop in home prices in many once-hot markets is among the most significant. In a recent survey, nearly 30 percent of homeowners reported that their houses decreased in value over the past year.² The decline in home equity makes it more difficult for struggling homeowners to refinance and reduces the financial incentive of stressed borrowers to remain in their homes. Mortgage performance data show a strong correlation between adverse house price changes and subsequent increases in mortgage delinquency and foreclosure (Avery, Brevoort, and Canner, 2007; Gerardi, Shapiro, and Willen, 2007). Investors who purchased homes in the hope of price appreciation seem particularly likely to walk away from "underwater" mortgages. Indeed, the role of investors in the housing market has increased markedly over time. According to data collected under the Home Mortgage Disclosure Act (HMDA), lending to non-owner-occupants has risen from about 5 percent of the home-purchase loans in the mid-1990s to about 17 percent of all purchases in 2005 and 2006 (Avery, Brevoort, and Canner, 2007). Mortgage delinquencies are also tied to local economic conditions; notably, several midwestern states struggling with job losses and slow income growth have seen increased delinquencies.

The deterioration in underwriting standards that appears to have begun in late 2005 is another important factor underlying the current crisis. A large share of subprime loans that were originated during this time featured high combined loan-to-value ratios and, in some cases, layers of additional risk factors, such as a lack of full documentation or the acceptance of very high debt-to-income ratios. In 2006, for example, the HMDA data suggest that nearly 40 percent of higher-priced home-purchase loans involved a piggy-back loan or second mortgage.³ Indeed, many defaults are occurring within the first few months of origination, well before payment resets occur on subprime ARM products.

Much of the weakening in underwriting standards appears to have happened outside of institutions regulated by the federal banking agencies. The HMDA data for 2006 show that more than 45 percent of high-cost first mortgages were originated by independent mortgage companies, which are institutions that are not regulated by the federal banking agencies and that sell almost all of the mortgages they originate. In this instance, this originate-to-distribute model appears to have contributed to the breakdown in underwriting standards, as lenders often found themselves able to pass on the credit risk without much resistance from the ultimate investors. For a number of years, rapid increases in house prices effectively insulated lenders and investors from the effects of weaker underwriting, providing false comfort.

Another concern is the substantial number of borrowers with subprime ARMs whose interest rates are scheduled to reset upward--about 1.5 million in 2008.⁴ The problem posed by resets is serious, but it may be mitigated somewhat by lower short-term interest rates and by the efforts of servicers, including those working with the Hope Now Alliance, to find solutions for borrowers facing resets, including interest-rate freezes (Hope Now Alliance Servicers, 2008). In addition, the FHA Secure plan, which the Federal Housing Administration (FHA) announced late last summer, offers qualified borrowers who are delinquent because of an interest rate reset and who have some equity in the home the opportunity to refinance into an FHA-insured mortgage. Recently, the Congress and Administration temporarily increased the maximum loan value eligible for FHA insurance, which will allow more borrowers access to this program.

² Analysis based on Reuters/University of Michigan Surveys of Consumers data provided to the Federal Reserve Board.

³ The Federal Reserve Board staff estimates are based on 2006 HMDA data. Additional information is available on the [Federal Financial Institutions Examination Council](#) website or in the [December 2007 Federal Reserve Bulletin](#).

⁴ The Federal Reserve Board's staff calculations are based on data from First American LoanPerformance and the Mortgage Bankers Association.

The current high rate of delinquencies and foreclosures is not confined to the subprime market. In 2007, about 45 percent of foreclosures were on prime, near-prime, or government-backed mortgages. Across market segments, delinquencies are rising fastest on the more-complex loans originated over the past few years. In part, that trend seems to be due to the fact that such loans were made to borrowers in weaker financial condition. In some cases, borrowers may not have fully understood the details of their loans, including the potential for large payment increases.

Federal Reserve responses

Effective responses need to build on an informed understanding of this complex picture. Thus, as these problems in housing emerged and deepened, the Federal Reserve System engaged with a wide array of market participants--including lenders, community groups, servicers, consumer advocates, public officials, and other regulators--to properly diagnose the problems and work toward sustainable solutions. The Federal Reserve System alone, of course, cannot resolve all of the problems in the marketplace, but we have responded thus far through our regulatory, supervisory, research, and community affairs functions.

Regulation and supervision

As part of a periodic review of our regulations under HOEPA, the Federal Reserve Board in 2006 began a systematic look at changes in the mortgage industry. Four public hearings held around the country confirmed evidence that we were gathering from other sources that the mortgage market was undergoing the significant changes with which we are all now familiar. Our concerns led us in 2006 and 2007 to issue, along with other federal and state regulators, a series of guidances to the institutions we supervise that covered nontraditional mortgage loans, subprime lending, and servicing practices. Those were good steps, but we also recognized that many of the problems we were beginning to see were a result of actions by companies and individuals not subject to our supervisory oversight. Thus, we conducted an additional HOEPA hearing, focusing on four specific areas: assessment of repayment ability; low- and no-documentation lending; escrowing for taxes and insurance; and prepayment penalties. As a result of a careful review of available data and information, we proposed new rules under our HOEPA authority in December, banning practices that we found to be unfair or deceptive. Significantly, bans on such unfair or deceptive acts and practices would apply to the entire mortgage industry, not just to institutions directly regulated by the Board.

Our goal was to produce clear and comprehensive rules to protect consumers from unfair practices while maintaining the viability of a market for responsible mortgage lending. The rules would apply stricter regulations to higher-priced mortgage loans, which we have defined broadly so as to cover substantially all of the subprime market.⁵ The regulations would be enforceable by state and federal supervisory and enforcement agencies as well as by consumers themselves, who could recover statutory damages for violations above and beyond actual damages.

The proposed rules cover a range of practices. First, the rules would prohibit a lender from engaging in a pattern or practice of making higher-priced loans that the borrower cannot reasonably be expected to repay from income or from assets other than the house. Of course, appropriate attention to the borrower's ability to repay is a fundamental feature of good underwriting.

⁵ Under the proposal, a "higher-priced mortgage loan" would have an annual percentage rate that exceeds the yield on comparable Treasury securities by 3 percentage points or more for first-lien loans or 5 percentage points or more for subordinate-lien loans.

Second, we found that the prevalence of "stated-income" lending led to many borrowers receiving mortgages that they could not afford. Consequently, we would require lenders to verify the income or assets they rely on to make credit decisions for higher-priced loans--standard industry practice, in fact, for most lending until quite recently.

Third, our proposal would require higher-priced loans to have an escrow account for real-estate taxes and hazard insurance. This rule would help ensure that borrowers can afford their payments and avoid the cases in which borrowers, especially first-time borrowers, did not understand that the monthly principal and interest payment was not the only financial obligation associated with homeownership. Escrowing has become standard practice in the prime market, and our proposal would make it standard practice for this part of the market, as well.

Fourth, the proposed rules would ban prepayment penalties in situations in which the borrower may be especially vulnerable. For example, prepayment penalties would be prohibited where the borrower's debt-to-income ratio exceeds 50 percent and, when permitted, would be required to expire at least sixty days before a scheduled increase in the loan payment. The rule would also ban prepayment penalties that could enable a "loan flipping" scheme, in which a lender or its affiliate refinances the lender's own loan at adverse terms for the borrower.

In seeking information and opinion about these four issues, the Board determined that additional problems needed to be addressed as well, and for all loans, not just higher-priced loans. Among the practices addressed by our proposal is the use of yield spread premiums (YSPs).⁶ Many consumers use mortgage brokers to guide them through a complex process and shop for the best deal. Unfortunately, consumers may believe that the broker has a responsibility to get them that best deal, which is not necessarily the case. In fact, the design of YSPs may provide the broker a financial incentive to offer a loan with a higher rate. Consumers who do not understand this point may not shop to their best advantage. Therefore, we would prohibit a lender, for both prime and subprime loans, from paying a broker an amount greater than the consumer agrees to in advance. Brokers would also have to disclose their potential conflict of interest. The combination of stricter regulation and better disclosure will not solve all the problems. We do believe, however, that this proposal will give consumers much better information and raise their awareness of brokers' potential conflict of interest while reducing a broker's incentive to steer a consumer to a higher rate.

To protect consumers and promote competition, our proposal would also ban seven specific advertising practices deemed unfair or deceptive. Under our rules, for example, mortgage originators would not be allowed to advertise a mortgage as having a "fixed" rate unless the advertisement also states clearly how long the rate or payment is fixed, and they could not advertise loans in one language but have important consumer disclosures in another. The proposal would also require that consumers receive loan-specific Truth in Lending Act disclosures early in the application process, when they can use the information to shop more effectively. The proposal also addresses certain practices in loan servicing that can cause problems for consumers, such as delays in posting payments to a consumer's account, and it acts to prohibit coercion of appraisers by lenders or brokers.

We believe these proposed rules will help protect mortgage borrowers from unfair and deceptive practices. At the same time, we did not want to create rules that were so open-ended or costly to administer that responsible lenders would pull out of the subprime market. So, our proposal is designed to protect consumers without shutting off access to responsible

⁶ A YSP is the present dollar value of the difference between the lowest interest rate the wholesale lenders would have accepted on a particular transaction and the interest rate the broker actually obtained for the lender. This dollar amount is usually paid to the mortgage broker. It may also be applied to other loan-related costs, but the Board's proposal concerns only the amount paid to the broker.

credit. We anticipate vigorous discussion through the public comment process that ends on April 8, and we will, as always, carefully consider this input before issuing final rules.

In addition to regulations, strong uniform oversight of different types of mortgage lenders is critical to avoiding future problems. Regulatory oversight of mortgage lending has become more challenging as the breadth and depth of this market has grown over the past decade. Other changes, such as the increased role of nonbank mortgage lenders, have added complexity.

To achieve more uniformly effective supervision, the Federal Reserve, together with other federal and state agencies, launched a pilot program last summer to conduct reviews of selected nondepository lenders with significant subprime mortgage operations. These reviews will evaluate the companies' underwriting standards as well as senior management oversight of compliance with state and federal consumer protection regulations and laws. We will take corrective or enforcement action as warranted. We plan to use this joint project as a vehicle for strengthening cooperation and coordination among federal and state agencies.

Research and community affairs

The Federal Reserve is addressing the foreclosure crisis in capacities other than that of a regulator, leveraging our strengths in research and data analysis, our regional presence, and the many contacts we have developed with local community groups, lenders, policymakers, and other stakeholders in this issue. Community affairs officers at the Board and the twelve Reserve Banks work with Federal Reserve research economists to anticipate and, where possible, mitigate foreclosure problems. They share detailed reports and information that help community organizations, nonprofits, state regulators, and others identify regions and neighborhoods most vulnerable to foreclosure and respond accordingly. For instance, NeighborWorks America recently used the Board's analyses to help identify geographic areas and neighborhoods in most critical need of \$130 million in emergency funds provided by the Congress to increase mortgage counselor capacity.

Solid analysis of available information is critical to crafting appropriate policy remedies, and the Federal Reserve has invested considerable resources into such studies. For example, a Federal Reserve Bank of Boston working paper has analyzed the factors that predict foreclosure, finding a particularly important role for declining house prices (Gerardi, Shapiro, and Willen, 2007). The Federal Reserve Bank of Philadelphia is conducting a five-year study of pre-purchase homeownership counseling. That study will provide important information on the benefits of counseling services in fostering sustainable homeownership and help us understand the long-term effects of financial-management skills on the credit worthiness of low- and moderate-income homebuyers.

In addition to this ongoing research, the Federal Reserve is supporting efforts to reach troubled borrowers and to raise awareness in communities about ways to prevent foreclosures. Since July, the community affairs offices across the Federal Reserve System have sponsored or cosponsored more than fifty events related to foreclosures, reaching more than 4,000 attendees including lenders, counselors, community development specialists, and policymakers.

There is also work to be done in mitigating the impact of unavoidable foreclosures on consumers and communities. Families who cannot sustain homeownership will need to find new places to live, highlighting the critical need for an adequate supply of affordable rental housing. Consumers going through foreclosure typically will see their credit scores drop, raising longer-term questions about their ability to rebound financially and perhaps pursue a more sustainable home purchase at some later point. High numbers of foreclosed homes in some communities also raise challenges, and perhaps opportunities. Because vacant homes, in particular, impose real costs on neighborhood and communities, forward-looking strategies to keep these homes occupied are important (Apgar and Duda, 2005). Some efforts are underway to prevent vacancies, as well as return vacant properties to active use;

some of these efforts may also help preserve the supply of affordable housing in areas that have experienced shortages.⁷ The Federal Reserve has recently undertaken a joint effort with NeighborWorks America to help communities develop strategies for neighborhood stabilization.

Conclusion

It is clear that rising home foreclosures and delinquencies significantly challenge many consumers and communities, and I hope I have conveyed today that the Federal Reserve is strongly committed to fully employing our authority, expertise, and resources to help alleviate their distress. We will continue to collaborate at the national, regional, and local levels with other stakeholders in the public, private, and nonprofit sectors to help to avoid preventable foreclosures and to address the consequences of the foreclosures that occur. In the longer term, through our regulations and oversight, we seek to promote responsible and sustainable lending that will allow more Americans to achieve their goal of homeownership.

References

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⁷ Some promising examples of programs to address vacancies already exist. For example, the Neighborhood Housing Services Redevelopment Corporation in Chicago has acquired hundreds of abandoned properties from such sources as the Department of Housing and Urban Development, the City of Chicago, bank foreclosures (that is, real estate owned), and private owners. The properties are then rehabilitated and sold to owner-occupants. In highly depressed housing markets, the worst-quality units are often demolished to mitigate safety hazards and reduce supply. For example, in Flint, Michigan, the Genesee County Land Bank acquires vacant properties through tax liens (see www.thelandbank.org).