EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Resource Library

10-16-2007

Remarks by Secretary Henry M. Paulson, Jr. on Current Housing and Mortgage Market Developments Georgetown University Law Center

Henry M. Paulson Jr.

https://elischolar.library.yale.edu/ypfs-documents/7228

This resource is brought to you for free and open access by the Yale Program on Financial Stability and EliScholar, a digital platform for scholarly publishing provided by Yale University Library.
For more information, please contact ypfs@yale.edu.

U.S. DEPARTMENT OF THE TREASURY

Press Center

Remarks by Secretary Henry M. Paulson, Jr. on Current Housing and Mortgage Market Developments Georgetown University Law Center

10/16/2007

HP-612

Washington, DC--Good morning. As students of law, business and public policy, you have an interest in real life case studies that combine financial markets and policy issues. Current developments in the housing and mortgage markets provide such an example. I will spend my time this morning reviewing the current state of the housing and mortgage markets, the implications for our capital markets and economy, and the role government and the private sector should play as we go forward.

The ongoing housing correction is not ending as quickly as it might have appeared late last year.

And it now looks like it will continue to adversely impact our economy, our capital markets, and many homeowners for some time yet. Even so, I believe we have a healthy, diversified economy that will continue to grow.

The housing correction has its roots in an eight-year period of exceptional home price appreciation which was fueled by an increased demand for, and an abundant supply of easy credit. Speculation also played a significant role, as the share of buying activity by investors or individuals buying second homes more than doubled from 2000 to 2005. Homebuilders responded to the extraordinary demand for more and larger homes as if it would last forever.

As mortgage lenders and investors reached for higher returns this "demand" pressure, coupled with our fragmented mortgage origination process, led to a decline in underwriting standards and a sharp increase in the issuance of riskier mortgage products. As demand for housing began to slow in 2004, originators, eager to maintain high mortgage origination volumes, further lowered their underwriting standards.

While adjustable-rate mortgages (ARMs) are not new, recent years saw an increase in hybrid-ARMs with low teaser rates, interest-only features, low- or no-down payments, and even negative amortization. In fact, about one-quarter of mortgage originations were non-traditional ARMs in 2005 and 2006, exposing mortgage holders to much greater risk than the traditional 30-year fixed rate mortgage with a 20 percent down payment.

This decline in lending standards was not limited to, but was most pronounced, in the case of subprime lending, which grew from only about 2 percent of mortgages in 1998 to nearly 14 percent in mid-2007. A significant percentage of the non-traditional ARMs were marketed and sold to subprime borrowers. Predictably, the result has been progressively higher rates of default on subprime mortgages.

The inevitable correction began in early 2006. Today, average nationwide home prices are barely up in the year through June, sales of existing single-family homes are down by nearly 25 percent from the peak in 2005, and the inventory of unsold homes has increased to levels last seen in the early 1990s. Housing should be analyzed by local or regional markets; averages can be misleading. Areas with the greatest price appreciation prior to the correction, such as Las Vegas, San Diego, central California and a number of cities in Florida, have seen declines. And prices are falling in other parts of the country where economic growth is slower, such as Michigan and parts of Ohio. Working through the housing correction will continue to take time.

As I mentioned earlier, mortgage defaults and foreclosures are rising. While the delinquency rate today is near the 2001 rate, there are over seven times more subprime mortgages today than there were in 2001. At the end of the second quarter of this year, more than 900,000 subprime loans were at least 30 days delinquent. Foreclosures are also up significantly – increasing about 50 percent from 2000 to 2006. Foreclosures on subprime loans are up over 200 percent in that same period. Current trends suggest there will be just over 1 million foreclosure starts this year - of which 620,000 are subprime.

Of the approximately 50 million outstanding mortgages in the U.S. today, approximately 10 million are subprime loans. Many have cited the statistic that 2 million of those subprime mortgages will reset to higher rates in the next 18 months. That statistic is true, relevant, and troubling, but it is not the complete picture of the risk going forward. Many of those borrowers will be able to afford their new mortgage

payment or they will be able to refinance into another more affordable mortgage. Yet, the problem today is not limited to subprime mortgages as the number of homeowners having trouble making payments on prime mortgages is also increasing. And finally, the wide geographic variation in home price trends adds to the complexity of sizing this problem with any certainty.

While innovation in the mortgage sector has brought benefits to our economy, the industry and homeowners, it has also introduced some challenges. Gone are the days when a homebuyer only went to the corner bank to take out a mortgage. Today, the mortgage process is disaggregated and less personal. A mortgage loan is likely to be originated, serviced, and owned by three different entities. Originators often sell mortgages to securitizers who package them into mortgage-backed securities, which are then divided and sold again to a global network of investors.

In today's decentralized system, a homeowner having trouble making payments often does not know where to turn for assistance.

In addition to affecting individual homeowners, the housing correction is also having a real impact on our economy. Annual housing starts peaked at an annual rate of almost 2.3 million units in early 2006 before falling off more than 40 percent through August of this year. Employment in residential building, including specialty trade contractors, has dropped by almost 200,000 since early 2006, offsetting about one-quarter of the jobs gained in the housing boom. It looked like housing construction had reached a bottom in the first half of this year, but starts have declined again since June and data on permit applications and inventories of unsold homes suggest further declines lie ahead.

We confront these current challenges against the backdrop of a strong economy – not just in the U.S., but globally. Indeed, this is the first housing downturn in the past three decades in which U.S. GDP growth has not turned negative. Business investment has expanded in recent months, our exports are being boosted by the strong economic growth of our trading partners and the healthy job market has helped consumer spending continue to grow.

But let me be clear, despite strong economic fundamentals, the housing decline is still unfolding and I view it as the most significant current risk to our economy. The longer housing prices remain stagnant or fall, the greater the penalty to our future economic growth.

So where do we go from here and what is the proper role for government?

First, our immediate concern must be for struggling borrowers whose primary residence is at risk. We must help as many able homeowners as possible stay in their homes. Foreclosures are costly and painful for homeowners. They are also costly for mortgage servicers and investors. They can have spillover effects into property values throughout a neighborhood, creating a downward cycle we must work to avoid.

Second, we must minimize the impact of the current downturn on our economy, recognizing the tension between such actions and the possibility of moral hazard.

When investors are relieved of the costs of bad decisions, they are more likely to repeat their mistakes. I have no interest in bailing out lenders or property speculators. Still, we must recognize the very real harms to families affected by the housing downturn. We must take steps to minimize the neighborhood effects and the macroeconomic effects of this housing market correction.

Third, we need to identify public policy changes that will reduce the likelihood of repeating some of the excesses of recent years while maintaining access to credit for able homeowners.

Helping Struggling Homeowners

Today's mortgage market is different than in the past and it requires policymakers to think and act creatively.

A first and important step is to bring mortgage servicers and the mortgage investors together in a coordinated effort to identify struggling borrowers early, connect them to a mortgage counselor and find a sustainable mortgage solution. In August, the President charged Secretary Alphonso Jackson and me to lead this effort. HUD and Treasury have been working closely with mortgage market participants to address the complexities of the modification process, especially in a mortgage market primarily based on a securitization model. The breadth of disaggregation in the mortgage market today is unprecedented, presenting a fundamental, practical problem that does not lend itself to an easy solution.

Recent surveys have shown that as many as 50 percent of the borrowers who have gone into foreclosure never had a prior discussion with a mortgage counselor or their servicer. That must change. Early intervention is critical – the earlier borrowers explore alternative options, the more likely they will find a workable solution and keep their home. We cannot expect to avert every foreclosure and, indeed, some are warranted. Even in years of strong housing performance, we witness several hundred thousand foreclosures. But today many homeowners out there can be helped, and we are committed to efforts designed to do just that.

Last week, I joined a group of mortgage servicers, counselors and investors as they launched a bipartisan alliance, called Hope Now, to coordinate efforts to reach more homeowners and find affordable solutions. I applaud this effort. This challenge is significant and only by working together will we reach more homeowners in need.

We have an immediate need to see more loan modifications and refinancing and other flexibility. For many families, this will be the only viable solution. The current process is not working well. This is not about finger pointing; it is about putting an aggressive plan together and moving forward. This alliance is dedicated to seeing that happen, and I expect to see results. I also call on those servicers who are not yet a part of this alliance to join. You have an obligation to help meet this challenge, and you can do so more effectively as part of an integrated effort.

Not all servicers are staffed for aggressive loss-mitigation. Preventing foreclosures is in investors' interest and investors must take an active role in demanding that all servicers, large or small, are pursuing all available loss-mitigation strategies. Today the industry doesn't have a thorough, standardized set of loss-mitigation metrics with which to evaluate servicers' performance. I expect the Hope Now alliance to quickly develop and begin reporting those metrics so investors, policy makers, and homeowners can measure results.

The efforts of this private sector alliance alone will not solve the problem. But it is a critical piece of the solution. As we work with them, we will all learn and improve the means of reaching and helping homeowners to prevent foreclosures.

We must also take steps to make more affordable mortgage products available for struggling homeowners. In August, the President renewed his call on Congress to pass FHA modernization to make affordable FHA loans more widely available. To facilitate mortgage workouts, the President has also called on Congress to temporarily eliminate taxes on mortgage debt forgiven on a primary residence.

FHA reform is moving through Congress, and I am hopeful that it will reach the President's desk soon. The tax relief proposal has cleared the House and is awaiting further action in the Senate. GSE reform has cleared the House, and also awaits action in the Senate. Congress should enact these bills as quickly as possible.

The GSEs also have a role to play in making affordable mortgage products more widely available. It is their mission. The secondary market in GSE mortgage-backed securities is functioning well. The GSEs could increase the flow of mortgage capital to refinance subprime borrowers if they securitized a greater number of these mortgages. To accomplish this, the GSEs must work closely with their private mortgage insurance company partners in the development of new products. The GSEs have additional capacity to help more blemished-credit struggling homeowners and we are hopeful that they will step up to this challenge.

In addition to these current initiatives, we welcome further input and will openly consider other ideas to assist struggling homeowners.

Public Policy Questions

We also need to make some changes in our laws and rules in order to prevent some of the excesses and abuses of the last few years from happening again. We must do so in a balanced, thoughtful way so as to avoid overreacting and introducing unintended consequences such as those that might shut off credit to able borrowers.

Homeownership brings substantial benefits to our society. For millions of Americans, their home is their largest financial asset, the key to their future financial security. And homeownership gives people a stake in their community that often leads to more civic involvement, better schools and safer neighborhoods.

While financial innovation has helped increase the homeownership rate in recent years, it has also introduced new complexities. Homebuyers today have more choices than ever before in finding a mortgage that best suits their circumstances. Yet, comparing the attractiveness of one mortgage product to another can be difficult. Homebuyer education and effective disclosure are critical to helping borrowers understand the risks of innovative mortgage products.

Furthermore, our complex and fragmented regulatory system complicates an already difficult situation. Existing federal laws address mortgage fraud, disclosures, fair lending, unfair and deceptive practices, and other aspects of the mortgage process. But the regulatory and enforcement authority varies across different federal agencies. States have also enacted an additional layer of regulation, typically applied only to certain institutions that operate within that state and enforced by the state agencies.

This patchwork structure should be streamlined and modernized.

Treasury is already spending considerable energy in developing ideas on how to improve the financial regulatory structure more broadly and, early next year, we will release a blueprint for comprehensive overhaul. Our goal is to improve oversight and allow our financial services industry to better adapt and compete in the global marketplace. However, fundamental changes to our regulatory system will take years to consider and implement. Homeowners should not wait years - we need to move now to make interim improvements to our current mortgage regulatory system.

We can do so by focusing on four key issues: disclosure, origination, predatory lending and liability.

We need simple, clear, and understandable mortgage disclosure. We must identify what information is most critical for borrowers to have so that they can make informed decisions. At closing, homebuyers get writer's cramp from initialing pages and pages of unintelligible and mostly unread boilerplate that appears to be designed to insulate the originator or lender from liability rather than to provide useful information to the borrower. We can and must do better.

The most critical facts, including potential future monthly payments, should be on a single page in clear, easy-to-understand language, to be signed by the borrower and the lender. In my judgment, this may have prevented many of the problems that we are seeing today.

The Federal Reserve is leading on this issue through a comprehensive review of the disclosure regime underlying the Truth in Lending Act. As part of this review, the Federal Reserve is engaged in extensive consumer testing to determine what types of disclosures provide the best information to consumers. I support the Federal Reserve's consumer-oriented approach -- this testing is critical to determining what improved disclosures are going to be most useful. This is hard and necessary work, but it is very important.

Borrowers have responsibility as well. Mortgage providers must offer clear, transparent and understandable information on the mortgage products they sell. And homebuyers have a responsibility to use that information. Buying a home today is a complex process, but that in no way excuses homebuyers from their obligation for due diligence. Just as investors in the stock market have a responsibility to understand the risks associated with their investment, homebuyers have a responsibility to understand their mortgages.

Secondly, we need to bring a higher level of integrity to the mortgage origination process. The development of a uniform national licensing, education, and monitoring system for all mortgage brokers is worth considering.

Some of the conduct and practices that I have learned about are shameful. It is no secret that, while not the norm, some fraudulent activity on behalf of mortgage brokers occurred.

Today, mortgage brokers are regulated at the state level, and the rigor of that regulation varies from state to state. State regulators have begun an effort geared toward uniform licensing and education requirements for mortgage brokers. We support this effort, but since other brokers are employed by federally-regulated entities, this effort will not cover the full universe of mortgage originators. We need to consider a national approach that builds upon the state efforts that are currently underway.

Licensing requirements should take into account prior fraudulent or criminal activity, and should require initial and ongoing education. At a minimum mortgage originators should be able to demonstrate a sound understanding of the products that they will be selling.

Common sense licensing requirements that are uniformly enforced could greatly help in weeding out the bad actors. A nationwide monitoring system that covers all mortgage originators could help prevent unscrupulous mortgage originators from moving across state lines or switching employers to evade detection. This is worth considering.

The third area that also warrants our focus is predatory lending.

Homebuyers must not be subject to unfair and deceptive lending practices. Here too, the Federal Reserve is engaged in a comprehensive review of its authority under the Home Ownership and Equity Protection Act, including its authority to broadly define unfair and deceptive practices. These rules would apply to the entire mortgage industry.

The Federal Reserve can inject greater uniformity and objective standards into the mortgage origination process, and I encourage them to do so.

In addition, there have been calls for legislation to address certain practices that are often associated with predatory lending, such as prepayment penalties or stated-income loans. There are clearly circumstances in which these product features are marketed inappropriately. There are also clearly circumstances in which any one of these features can make sense for the borrower and significantly improve credit availability.

We need to strike a careful balance of providing adequate consumer protection without limiting overall credit availability or consumer choice, especially for those who most need that flexibility.

This is a difficult balance to achieve because each lending determination is relatively unique based on the different facts and circumstances associated with each borrower. Yet, I am hopeful that we can do it.

In my view, it makes a great deal of sense to recognize that certain products are right for some borrowers and not for others. The Federal Reserve has already stated that it will examine some of these specific issues including prepayment penalties, stated-income loans, escrow accounts and ability-to-repay considerations.

The fourth issue that has garnered attention is whether greater liability should be imposed on securitizers and investors. In my view, this is not the answer to the problem. Imposing broad liability provisions on investors and securitizers would very likely generate significant unintended consequences. It would potentially paralyze securitization, a process that has been extremely valuable in extending the availability of credit to millions of homeowners nationwide and lowering the cost of financing. Again, balance is critically important. Congress should proceed with extreme caution so as to avoid cutting off investment inflows to the housing market.

Before concluding I will briefly summarize two other broad-based capital markets related initiatives under way that will also address some of the problems which have arisen in the mortgage market.

Broader Capital Markets Issues

The President's Working Group (PWG) – chaired by Treasury and consisting of the Federal Reserve, the SEC, and the CFTC -- is leading a comprehensive review into the policy implications resulting from current challenges in the credit markets. A number of these issues are directly tied to the mortgage markets; others affect the capital markets more broadly. Given the global nature of our financial markets, I will also work with the G7 and through the Financial Stability Forum to address several of these issues.

One area the PWG has already addressed is hedge funds. Back in February, the PWG produced forward-leaning guidance for the industry and its participants including regulated financial institutions which serve as prime brokers and counterparties to hedge funds. Our principles and guidelines serve as a foundation to enhance vigilance and market discipline, strengthen investor protection and guard against systemic risk. While a small number of hedge funds were forced to wind down in recent months, there were no systemic events associated with their closure, and hedge funds have not proven to be a significant problem.

The real irony is that the material problems arising in recent months were in regulated institutions in certain markets. Many regulated institutions, both in the U.S. and elsewhere, appear not to have fully appreciated all of the risks associated with the securitized assets on their balance sheets or the many risks associated with commitments to provide liquidity to off-balance sheet vehicles, such as conduits and structured investment vehicles.

Deteriorating subprime mortgage performance over the last several months led investors to question their assumptions about the credit quality and value of many assets. In July, as default rates surpassed their models' projections, ratings agencies downgraded billions of dollars worth of subprime mortgage backed securities.

The statement by ratings agencies that they were unable to accurately characterize the default probabilities of subprime mortgages created broader uncertainties in financial markets. Not surprisingly, investors reacted by reassessing and repricing risk across all market segments that relied heavily on the use of ratings, particularly in complex, structured credit products. Predictably, given the interconnectedness of our capital markets, the influence of this development was global.

The reassessment of risk has played out more rapidly in some markets than in others. In certain asset classes, risk has been reassessed and repriced fairly quickly as investors gained confidence in their fundamental assessments. In such markets, liquidity has returned and markets are operating normally. Good examples would include world equity markets, sovereign debt markets, and investment grade corporate debt.

On the other hand, some sectors that are characterized by more complex securities or that rely more heavily on securitization and ratings -- such as the jumbo mortgage market, the leveraged loan market, and the asset backed commercial paper market -- are still operating under some stress with impaired liquidity. Conditions are better than they were a few weeks ago, and we continue to see improvements, but it will take longer for these sectors to fully recover.

Market–based efforts and initiatives are emerging to address some of the current challenges in the capital markets. I am pleased that yesterday a group of commercial banks announced their intent to establish a master conduit to help improve liquidity in the asset-backed commercial paper marketplace. The market participants and investors who may voluntarily participate in this enhanced facility recognize the benefit of such a structure. The leading financial institutions as well as investors realize the importance of improved liquidity in the high quality, asset backed commercial paper sector – a sector of the market with great importance for securitized assets such as mortgages, as well as for the broader capital markets.

This is promising. Just as in the mortgage market, we need to work on parallel tracks, addressing current concerns as well as addressing policy issues to avoid repeating the recent market turmoil.

Treasury and the President's Working Group are conducting a comprehensive review of such issues, including two areas that have a direct relationship to the events in the mortgage markets.

First, it is clear that we must examine the role of credit rating agencies including transparency and potential conflicts of interest. We must also assess if regulations and supervisory policies are encouraging an over-reliance on ratings by financial institutions and investors.

Second, we must continue to address financial institution risk management and related regulatory issues. In particular, we must ensure that they adequately take into account the risks posed by protracted periods of market illiquidity or the risks posed by a reduced ability to securitize and sell loans, including leveraged syndicated loans and mortgages.

Our bank regulators must evaluate regulatory capital requirements applicable to bank exposures to off-balance sheet vehicles. Transparency is important here, so we will also review the accounting rules that are applicable to off-balance sheet vehicles.

We will examine other areas that are indirectly related to the mortgage market which nevertheless impact our capital markets, ranging from enhancing the management of counterparty credit risks, to market infrastructure issues, to issues surrounding reporting and risk disclosure, to evaluating the important role of investors and, finally, how our long-standing regulatory structure and tools respond to today's continuously evolving financial system.

Conclusion

Innovation is the hallmark of our capital markets and it brings with it significant benefits to individual investors and our overall economy. However, innovation often outpaces regulation. That is not surprising, and we would not want it the other way around. If it were, we would have less competitive and efficient markets, which would ultimately stifle economic growth. It would mean fewer jobs and lower wages.

However, when problems arise, we need to shine a light on them and move to address them in a balanced way. Today it is clear that we need to do just that. We have a lot of work to do. We need to ensure yesterday's excesses are not repeated tomorrow.

As the mortgage and credit markets continue to adjust, all of us – policymakers and market participants -- will no doubt learn new lessons. Through a dedicated effort by all parties, we will work to strike the right balance, protect consumers and make mortgage capital widely available to Americans ready to be homeowners.

-30-