Keynote Address by
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Good afternoon. Thank you for joining us for today's joint Federal Reserve-FDIC conference on "Mortgages and the Future of Housing Finance." Our goal in organizing this conference was to bring together some of the best minds in policy, industry and academia to present research and exchange views on the difficult problems that the mortgage crisis has exposed and to consider what changes must occur going forward. I am confident that these discussions will contribute to a better understanding of these issues.

I would like to devote my remarks to discussing steps we must take now to restore public confidence in our housing finance system.

Financing the American Dream

Owning your own home has always been a powerful American ideal. But through the early decades of the 20th century, our financial system was not particularly effective in making credit available to would-be homebuyers. While savings and loan associations frequently did provide long-term, amortizing loans, the lack of a secondary market meant that their financial resources were limited to the savings of their members. Other providers, including commercial banks, tended to make only short-term, non-amortizing balloon loans that required borrowers to refinance every few years.

Rapid growth in mortgage lending during the 1920s on this unstable institutional ground set the stage for a rapid rise in mortgage defaults as home prices fell by half in the Great Depression. It was amid the policy interventions and financial reforms of the 1930s that the modern governmental role in mortgage finance began to take shape.

In response to the crisis, we saw the introduction of the Federal Home Loan Bank System, the Home Owners Loan Corporation, the FHA, Fannie Mae, federal deposit insurance, and a federal charter for savings and loan associations. These government agencies and institutions became the foundation for a truly revolutionary consumer financial product: a long-term, non-callable, fixed-rate amortizing mortgage loan that could depend on stable sources of funding, and that could trade in an organized, liquid secondary market. It is hard to overstate the importance of these developments in

creating the era of prosperity enjoyed by American households in the years following the Second World War, when our system of mortgage finance was a model for the world.

Cracks in the Foundation

But with the benefit of hindsight, we are now able to see the cracks in the foundation of this prosperity that few were able to appreciate at the time. Investment in housing flourished, while in other sectors, needed investment lagged.

For example, we were more adept at financing and building suburban homes than at providing the transportation and other public infrastructure needed to support these new communities. As a result, Americans today spend more than twice as much time stuck in traffic than they did 30 years ago.

And our system of mortgage finance, once a model for the world, has turned out to have serious flaws. Thrift institutions saw their net worth decimated when the high and volatile interest rates of the late 1970s and early 1980s revealed the industry's heavy exposure to interest rate risk.

Many S&Ls gambled for survival with risky commercial real estate loans that ultimately broke the savings and loan insurance fund. The main lesson of the S&L crisis here in Washington was the danger of moral hazard. The crisis led to reforms designed to limit the ability of federally insured institutions to take on balance-sheet risk at the expense of the deposit insurance fund. We then saw a wholesale shift in mortgage funding away from savings institutions and toward mortgage securitization, first by the government-sponsored mortgage enterprises and then by private issuers.

By the mid-1990s, the government-sponsored enterprises would finance more than half of all residential mortgage debt. At the same time, private securitization also began to grow rapidly. Issuance of private mortgage-backed securities rose from less than $50 billion in 1995 to a peak of more than $1 trillion annually in both 2005 and 2006 – at the height of the housing bubble.

The Logic and the Flaws of Securitization

The logic that drove growth in securitization was built around what has been called "the unbundling of financial services." No longer was a single institutional lender responsible for originating, underwriting, funding, and servicing its mortgage loans. With securitization, these functions were parceled out to different entities. At the same time, instruments used to fund mortgage lending were customized to particular risk preferences and sold to institutional investors and the global financial markets. Two government-sponsored companies – Fannie Mae and Freddie Mac – took advantage of their implicit government backing to build large retained investment portfolios and take on too much risk at the expense of the public. Figures released last week by the FHFA indicate that crisis-related losses to taxpayers as a result of this backing will eventually

total between $142 and $259 billion. But at least the GSEs started with a basic set of underwriting standards that covered most of the mortgages they purchased or guaranteed.

At the height of the housing bubble, private mortgage-backed securitization devolved into an anything-goes bazaar where brokers and lenders kept lowering standards, while underwriters, issuers, and ratings agencies kept dreaming up new ways to package these risky loans into highly rated securities that belied the underlying risks. In a bid to recapture market share, the GSEs lowered their underwriting standards, following the private-label mortgage market into large purchases and guarantees of poorly underwritten loans.

In the end, the flaws of the system boiled down to three fundamental and interrelated problems: misaligned incentives, implicit government support, and the emergence of financial companies that were Too Big To Fail.

All along the chain of securitization – from originators, to securities underwriters and ratings agencies, to investors and regulators – insufficient attention was paid to both safety and soundness and basic consumer protection. With each of these parties acting in its own best interest, the system as a whole lurched toward disaster.

The Robo-Signing Controversy and the Need to Modify Mortgages

The latest controversy over securitization relates to concerns that legal documents required for foreclosure have in some cases been improperly exercised – or "robo-signed" – by mortgage servicers. We are working closely with our fellow regulators to get to the bottom of this problem. Our initial review suggests that FDIC supervised non-member state banks have limited exposure to the robo-signing situation, but we continue to work on this issue with the regulators of other insured institutions through our backup examination authority.

In addition, we are in contact with investors who have purchased failed bank assets from the FDIC – both our loss-share partners and structured transaction managers – to verify that their foreclosure claims are compliant with the law. We have made clear that losses associated with improperly executed foreclosures will not be eligible for loss-share arrangements until problems are appropriately remediated.

In retrospect, there were warning signs that servicing standards were eroding. Those signs should have caused market participants and regulators alike to question current practices. For example, servicing fees declined significantly over the past several years. We should have been asking how servicers were able to achieve such efficiencies without sacrificing quality. Sadly, those types of questions were not asked.

As regulators embark on changes to our supervisory programs, we need to get back to basics and spend more time understanding and – where necessary – questioning the business models that drive the earnings and create the risks present in the banking

system. The robo-signing controversy underscores just how time-consuming and expensive foreclosure really is for all parties concerned.

As I have repeatedly said, foreclosure should be a last resort, undertaken only where bona fide loan restructuring efforts have not succeeded and all legal and procedural requirements have been fulfilled. At the same time, I fear that the litigation generated by this issue could ultimately be very damaging to our housing markets if it ends up unduly prolonging those foreclosures that are necessary and justified.

The regrettable truth is that many of the properties currently in the foreclosure process are either vacant or occupied by borrowers who simply cannot make even a significantly reduced payment and have been in arrears for an extended time. Ultimately, this problem will require some type of global solution. And in developing that solution, I would suggest that all interested parties consider some type of "triage" on foreclosures, perhaps providing safe-harbor relief if the property is vacant or if the servicer offered a meaningful payment reduction – say a minimum of 25 percent – and the borrower could still not perform on the loan.

We know from experience that reducing the monthly payment through modification raises the chance that the borrower will make good on the loan. We also know that in too many instances, servicers have not made meaningful efforts to restructure loans for borrowers who have documented that they are in economic distress. Our research, based on loans modified by the FDIC at Indy Mac, shows that raising the size of the payment reduction from 10 percent to 40 percent or more can cut redefault rates by half.

Given foreclosure backlogs and bloated housing inventories, timely and meaningful loan restructuring efforts make economic sense now more than ever. Unfortunately, those efforts have been impeded by overly complicated processes and insufficient servicing staff.

In a larger sense, the robo-signing controversy is just another indication of the need to improve institutional practices all along the chain of securitization -- from origination, to securities underwriting, to servicing. The misaligned incentives that have been built into the securitization process have left back-office operations far too weak to support a robust system of mortgage finance.

If we want to rebuild housing finance into a more solid foundation for our economic future, we will need to act decisively to fix the underlying problems that led to the current crisis.

Reforming and Restarting Private Securitization

We must start by restoring market discipline to our mortgage finance system. This requires that the securitization process incorporate features that empower investors to

perform full due diligence on the quality of mortgages going into securitizations through loan level disclosures.

It also requires that the economic incentives of issuers of securitizations be aligned with the long-term performance of securitized loans. These steps require: greater transparency in disclosures and transaction structures, clearer documentation; servicer incentives that are aligned with the investors as a whole; third-party oversight that will assure effective loss mitigation for troubled mortgages; and, finally, very high, easily verified regulatory underwriting standards or risk-retention requirements for issuers that will require that they take some share of every investor loss.

Transparency, clear authority to act, and realigned incentives support strong loan quality by bringing the pressure of market discipline to bear on all components of the process. The FDIC recently took the initiative to establish standards for our long-standing safe harbor for securitizations. Our final rule, approved in September, establishes standards for disclosure, loan quality, loan documentation, and incentives and oversight of servicers.

These standards are aligned with the SEC's new proposals on disclosures and will incorporate the interagency risk-retention standards required by Dodd-Frank, once they are adopted. Our new safe-harbor standards create a comprehensive set of incentives to assure that loans are made and managed in a way that achieves sustainable lending and maximizes value for all investors. And the rule is fully consistent with the Dodd-Frank mandate to apply a 5 percent risk-retention requirement on all but the most conservatively underwritten loans.

Given the recent change in accounting standards that made our existing safe-harbor rules obsolete, as well as the urgent need to restore investor confidence in the securitization process, we believed it was vital to give the market some clarity and realign our safe harbor with the changed accounting standards.

Ending Implicit Forms of Government Support

Too Big To Fail is just one example of the type of implicit federal backing of selected private companies that has taken root in our financial system over time. Among the most prominent examples, of course, are Fannie Mae and Freddie Mac, which the market regarded as having the implicit backing of the federal government long before they were placed in conservatorship in September of 2008.

Whenever investors are led to believe that policymakers will not allow a company to fail, market discipline is weakened. The inevitable result is more risk taking that only raises the value of the implicit government backing.

Shareholders and company insiders capture most of the upside gains over time, while taxpayers get stuck with potentially catastrophic losses in a time of crisis. Clearly, any such arrangement can only be regarded as a failure of government policy. That is why,

when it comes to reforming the mortgage GSEs, we must rule out a continuation of the type of implicit government backing they have enjoyed in the past.

Homeownership remains an important national priority. And maintaining stability in mortgage finance through economic and financial cycles may well require some form of ongoing government support for securitization. If so, then that support must be publicly acknowledged, appropriately priced, clearly delimited, subject to audit, and backed by the full faith and credit of the U.S. government.

These are the basic rules that govern the FDIC's deposit insurance program. Any program of government support to the marketplace – no matter how well intentioned – that does not adhere to these basic rules potentially exposes taxpayers to unexpected and unpredictable loss, and could undermine public trust in both the market and the government.

Covered Bonds in Receivership

At the same time, well-intentioned rules to promote certain types of financial activities can, unless carefully structured, result in implicit government backing that leads to problems down the road. This is why the FDIC supports covered bond legislation, but has expressed concerns about recent legislative proposals that could shift risks from investors to the Deposit Insurance Fund.

The FDIC would welcome balanced legislation to encourage the development of a viable U.S. covered bond market by clarifying the rights and responsibilities of issuers, investors and regulators. Covered bonds are simply general obligation bonds issued by a financial institution that are backed by a pool of loans.

Covered bonds could be a valuable source of liquidity to finance mortgages, and properly structured, they provide a way to transfer risk broadly to private-sector investors, rather than the U.S. government. However, improperly structured, they could lead to another system of implicit government guarantees.

In particular, we should take care in looking to the European model, which provides for virtual government backing of covered bonds. For instance, while covered bonds represent a potentially important source of funding for mortgage loans, some proposals would give covered-bond investors a super-priority in receivership, which would effectively transfer credit and pre-payment risk from covered bond investors to the FDIC.

This would result in decreased market discipline from investors who know that their risks are essentially back-stopped by the FDIC. The increased costs to the deposit insurance fund would be borne by all banks, large and small, through higher deposit insurance premiums. I know this is not the intention of Congressional proponents of a covered bond market, and we want to work constructively with them to resolve this issue.

Conclusion

The financial reforms that grew out of the Great Depression created government institutions that supported financial stability and the availability of mortgage credit for decades after they were established. But the recent crisis in mortgage finance has revealed critical flaws in our system that compel us to make far-reaching institutional changes that will determine the shape of our financial sector for decades to come.

Instead of creating vast new sources of institutional support for the financial sector, today's reforms are geared more toward clarifying the rules that govern the relationship between the government and private financial companies. Just as Dodd-Frank clarifies the rules for resolving systemically-important financial institutions, we must now clarify the rules for government support of mortgage securitization. This is the hard work of good government. By participating in this conference you show your commitment to getting the details right, and making our system more stable and more efficient in the decades to come. Thank you.

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