Remarks by
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It is truly a sign of unusual economic times when a group of high tech leaders asks a bank regulator of all people to speak to them.

But bank regulation – or perhaps I should say weaknesses and holes in our bank regulatory structure — lie at the heart of our current housing predicament. California has been hit particularly hard and we've been working closely with Governor Schwarzenegger on foreclosure prevention in California.

So I hope I can shed some light on what happened, and what needs to be done to stop the hemorrhaging and turn things around.

This is extremely important to places like Silicon Valley. As a nucleus for high-tech innovation and economic growth, your economic vitality is critically important to the nation, and to the global economy. Despite your impressive track record for job creation and high wages, you're not immune to the economic challenges that we're now facing across the nation.

While housing conditions are softening in Silicon Valley, like most of the county, home prices remain very high. San Jose is the most expensive housing market in the nation. More than half of San Jose homeowners spend at least a third of their monthly income on housing.

Affordability products

Rapidly escalating home prices have been a driving force behind the growth of the so-called nontraditional mortgages during the past few years in what is known as the "Alt-A" market. These are higher risk mortgages typically given to borrowers with good credit. Many Californians have them.

As home prices rose, one way to keep the monthly payment in check, for a while anyway, was to take on an interest-only or payment-option mortgage. These so-called "affordability products" permitted zero or negative amortization of principal in the early years. But that was followed by potentially large increases in the monthly payments once amortization kicked in (typically after five years).

As long as rapid home price appreciation was the norm, these loans caused few problems. Homeowners could simply refinance out of the mortgage before the "payment shock" kicked in. Now that prices are falling, we see more people running out of options. With insufficient equity to refinance, some are facing a doubling of their monthly mortgage payments.

Eighty-five percent of those with payment-option loans currently owe more than they did when they originally took out the loan. And about 75 percent of these borrowers have been making the minimum payment.

Nontraditional mortgages were also the instrument of choice for investors and speculators hoping to flip the property for a quick profit, only to see the market turn on them before they could do so.

The problems associated with these products are already evident. We're seeing a rash of "first year defaults" among Alt-A loans to speculators and borrowers who should never have been qualified for the loan in the first place.

Diagnosing the subprime mortgage problem

Problems from lax lending began to spread last year in the subprime market. Unlike Alt-A, subprime mortgages are high interest rate mortgages given to people with scant credit records or blemished credit histories. Until recently, the majority of loans made in the subprime market were so-called 2/28s and 3/27s. These adjustable rate loans have initial two to three year starter rates of 7 to 9 percent with steep increases in payments after the initial period.

Frequently, these loans were given to families already struggling to make ends meet who were encouraged to buy or refinance homes with loans they never had a realistic hope of repaying.

And a disproportionate number of these loans were made to working class and minority neighborhoods. As with Alt-A mortgages, these loans performed as long as home prices went up, and interest rates remained low. That allowed borrowers to refinance out of them before the payment shock, generating fees and prepayment penalties for brokers, lenders, and investors.

Originators in search of loan volume aggressively marketed them to subprime borrowers who, by definition, either had troubled credit histories or very little experience with borrowing money.

In addition to payment shock features, both Alt-A and subprime loans typically had other high risk elements, such as lack of income verification, high loan to value ratios, and second liens.

Market conditions: what next?

As home prices have fallen in many areas of the country, distress in the mortgage markets has intensified. More and more borrowers are unable to refinance out of unaffordable "payment shock" loans. And an increasing number of borrowers are finding themselves in a very tough spot, owing bigger mortgages than their homes are worth.

When borrowers stop paying on their mortgages, the standard response of many loan servicing companies has been to initiate foreclosure. In a rising housing market, this might be the best course of action for the investors who own the loans. But in today's troubled housing market, a policy of mass foreclosures is self-defeating for investor and borrower alike.

Mass foreclosures are costly and damaging to neighborhoods and communities. They add housing stock to markets already laden with high inventory. And they can result in even bigger losses for investors.

A better alternative is to modify the loan. That is, renegotiate the loan terms between the borrower and the lender. This takes into account both the changes that have taken place in the marketplace, and the high costs that foreclosure imposes on all parties.

Loan modifications are a standard practice for lenders and borrowers who have long-term banking relationships, with the bank typically holding the loan. But it's much tougher today because virtually all the problem loans have been sold, pooled, and resold as securities to investors.

When the loans are securitized, they are serviced by third parties under "pooling and servicing agreements." These agreements typically require the company servicing the loan to collect payments and, if there is a problem, maximize recoveries. Unfortunately, many servicers have tended to proceed directly to foreclosure.

A question of investor lawsuits

Some servicers have told us that they are afraid to systematically modify loans for fear that investors will sue them. But the smarter question that loan servicers ought to be asking is whether there's a bigger risk of a lawsuit if they don't do modifications. Given today's market conditions, foreclosure will likely cost investors a lot more money than the lower returns they would get from modified loans.

If need be, Congress could step in to protect loan servicers from investor lawsuits by clarifying that systematic loan modifications are consistent with, if not required by, their fiduciary obligations to investors. My hope is that investors wake up to what's going on and push hard for loan modifications, not fight them.

If your companies have exposure to mortgage backed securities, whether directly or through employee retirement funds, I urge you to ask questions about who is servicing the loans backing those securities. And ask whether they are making meaningful efforts to modify distressed loans as an alternative to costly foreclosures.

Fast-tracking loan modifications

One simple modification that I have called for is to extend high subprime starter rates for five years or longer for all owner-occupied homes where borrowers have been making timely payments, but can't afford higher reset payments. Such a systematic approach can be much faster than a loan-by-loan process. And speed is crucial, especially for subprime mortgages. Some 1.7 million of them will reset in the next two years, most by the end of this year.

This proposal was the impetus for an agreement Governor Schwarzenegger reached last November with major servicers in California. In December, Treasury Secretary Paulson announced a similar national agreement, working with the American Securitization Forum.

Lately, there are signs that major mortgage servicers have been accelerating loan modifications. Lenders and servicers must keep up the pace. And their efforts must be partnered with prompt and transparent reporting that permits independent analysis of their progress.

Write downs will be necessary

Servicers should also be more aggressive about writing down principal amounts when necessary to make the loan affordable. Congress has made this a more viable option by approving the Mortgage Forgiveness Debt Relief Act in December. By taking the tax liability issue off the table, which this law does, principal write-downs are now a more realistic alternative.

Many servicers were initially reluctant to freeze interest rates in a systematic manner. But as market conditions deteriorated, it became evident that streamlining modifications would provide the greatest benefit to both borrowers and investors.

Now, servicers and investors may be reluctant to write down the mortgages. But in this environment of declining home prices, writing down the values of loans to an amount that borrowers can pay in a sustainable manner, may result in smaller losses to investors than foreclosure.

Just as servicers were concerned that modifying loans could expose them to litigation from investors, servicers may also be concerned that writing down loans could lead to litigation. But if a reasonable write-down results in a loss that is significantly smaller than the loss that would result from foreclosure, I would again argue that the servicer, whose duty is to maximize the return on the pool, has more to answer for by doing nothing.

Unfortunately, there are no silver bullets. There will be continued pain in the months ahead as we work through the subprime, and the non-traditional mortgage resets. But more aggressive use of streamlined loan modifications by loan servicers can do much to ease the pain.

Need for market rules

Going forward, one thing is abundantly clear: The home mortgage market needs strong rules. Much of the lax lending I have been talking about developed outside the regulated banking sector by lightly regulated mortgage finance companies. However, as these nonbank lenders increased market share through aggressive use of easy credit, some of the larger banks and thrifts also began easing credit standards, which widened the mess we are now in.

We need rules that restore common sense and basic notions of fair play. We need rules that apply across-the-board so they protect all homeowners, regardless of who their lender is, or what state they live in. We need rules that apply to banks and nonbanks alike. We need to protect responsible lenders from the downward spiral of "race-to-the-bottom" competition. And we need rules that restore transparency to a secondary mortgage market now frozen because of uncertainty and distrust.

When you stop and think, it's astonishing that with mortgages being by far the largest single financial asset for most American families, there is no regulatory regime that applies consistent, across-the-board standards to protect all borrowers.

Compare that with the securities industry. Brokers are subject to fairly rigorous testing and licensing requirements that are administered by strong, self-regulatory organizations (SROs). Federal law provides for effective enforcement through these organizations and the SEC as well as private rights of action. And suitability rules apply to all securities investors, which in turn, give legal incentives for brokers to take extra care in recommending investments.

So what does this boil down to? It means that your legal protections may be greater for a $2,000 mutual fund investment than they are when you buy a $300,000 house.

Fortunately, the Federal Reserve Board does have the authority to set lending standards that apply to banks and nonbanks alike. Under Chairman Bernanke's leadership, the Fed recently proposed amending its truth-in-lending regulations to deal with the fallout from subprime and nontraditional lending. While we believe these rules could be strengthened in key respects, they are an important step forward.

Strong, uniform rules will not only protect consumers, but will benefit lenders as well. And they could help initiate the process of recovery for the subprime secondary mortgage market. They will begin to reorient lender incentives away from loan origination volume, and closer to long-term performance ... which is in everyone's best interest, from Main Street to Wall Street.

Such rules don't have to be overly burdensome or complex. They just need to reinforce common sense traditional standards of good clean underwriting and customer fairness.

First, we need an enforceable standard to require lenders to determine if a borrower has the ability to repay. Lenders, by definition, are to exercise due care in qualifying borrowers for loans that they can repay. In the current crisis, this means that lenders should qualify adjustable rate mortgage borrowers to assure that they can repay the loan at the lower initial rate, as well as the higher rate when the loan readjusts. In bank regulator jargon, we call this underwriting at the fully indexed rate.

An ability-to-repay-standard also means that lenders should document that borrowers have sufficient income to make their projected payments.

Yes. It's time we got back to the days when lenders worked to verify income, as opposed to inviting misrepresentation and fraud through "stated income" loans. We also need to end compensation schemes that give mortgage brokers every incentive to steer borrowers into the highest-rate-product possible. And we should limit or eliminate prepayment penalties, which are inherently anticompetitive and in some cases, abusive. Finally, we need improved disclosure rules to enable investors to better analyze the credit quality of mortgage assets backing the securities they buy.

No doubt some will argue that more stringent rules will reduce future credit availability. But I would argue (and forcefully argue) that credit is tight today because of the lack of clear, consistent standards for all mortgage lending.

Conclusion

Ronald Reagan once said that the purpose of government to protect us from each other, not to protect us from our selves. Markets work best when consumers are able to understand the products and services they are getting, and the prices they are paying for them in arms-length transactions.

Markets break down when prices are hidden, when essential product features are too complex to understand, and when there are gross disparities in the knowledge and sophistication level of the parties to the transaction. The recent problems in the mortgage market and the economic harm they are causing clearly show the need for government to protect us from each other with basic safeguards that provide a floor of protection as markets change and evolve over time.

Traditionally, downturns in the real economy lead to problems in the credit markets. Today it's the other way around. Pervasive lax lending standards in the credit markets are contributing to stress in the real economy. And that means that as leaders of the real economy, lax lending should be of great concern to you.

I urge you to join in the call for a return to common sense and back to basics lending standards. Rules that will: protect borrowers, protect responsible lenders, protect neighborhoods, and that will ultimately protect you, your businesses, and a sustainable, real economic future.

Let's close this sorry chapter in the history of mortgage finance. And going forward, let's have rules that let capitalism and markets work the way they were intended to keep our nation strong.

Thank you.

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