Remarks by
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For many decades U.S. government policies have promoted housing in general and homeownership in particular. These policies have been very successful in raising the quality of our housing stock while extending the benefits of homeownership to more than two-thirds of American households.

But now that our housing bubble has burst, a critical task lies before us: rebuilding U.S. mortgage finance on a sounder footing, not only to restore the confidence of homeowners, investors and lenders, but more fundamentally to restore balance to our broader economy.

There is no single fix that will restore confidence or immediately repair the dislocations that have taken place in housing and mortgage markets. But if we are willing to take bold steps, and return to the fundamentals of mortgage lending and securitization, we can get back to a more rational world where consumers are protected, risks are contained, and our scarce resources are allocated to their highest and best use.

Underwriting: Back to Basics

First, we must recognize that the financial crisis was triggered by a reckless departure from tried and true, common-sense loan underwriting practices.

Traditional mortgage lending worked so well in the past because lenders required sizeable down payments, solid borrower credit histories, proper income documentation, and sufficient income to make regular payments at the fully-indexed rate of the loan. Not only were these bedrock principles relaxed in the run-up to the crisis, but they were frequently relaxed all at once in the same loans in a practice regulators refer to as "risk layering."

As all of you know, the long-term credit performance of a portfolio of mortgage loans can only be as sound as the underwriting practices used to originate those loans.

Macro Implications of Faulty Underwriting

The FDIC is in the midst of cleaning up the damage wrecked by the bursting of the greatest real estate bubble in U.S. history. A key lesson of this crisis is that weak underwriting practices have macro implications for home prices, economic performance, and the stability of our financial system.

Let's look back for a moment to how the housing crisis unfolded. At the end of 2003, we were already well into a historic housing boom. Over the previous decade, nominal home prices had risen by 81 percent, while per capita disposable incomes were up by just over half. You might have expected a cooling off in home prices after this remarkable run. Instead, during the next three years we saw an acceleration of home price increases.

Between 2003 and 2006, average prices rose by another 38 percent, almost two and a half times faster than incomes. It was this surge in home prices, preceded by a decade of steady increases, that took prices far above any reasonable measure of the fundamentals.

More than any other factor, what explains the post-2003 acceleration of home prices is an extreme deterioration in mortgage lending practices. For example, subprime mortgages rose to more than 20 percent of all originations between 2004 and 2006, compared with less than 10 percent in 2003. And so-called Alt-A mortgages rose four-fold between 2003 and 2006. Many did not require amortization of principal during the first five years, and many required little or no documentation. By early this year, almost 40 percent of 2006 Alt-A vintage loans were in default.

The Role of the Capital Markets

So, why it is that these changes took place so suddenly? One reason was the decline in prime mortgage originations after the refinancing boom of 2003. Almost $4 trillion in mortgages were originated in 2003 as prime mortgage rates fell to their lowest level in more than 40 years. That was a tough act to follow. Lenders who wanted to try to keep up the pace turned to subprime and nontraditional mortgages, most of which were securitized by private issuers of mortgage backed securities.

From 2003 through 2006, the share of total U.S. mortgage debt held by these private issuers more than doubled, from 9 percent to just over 20 percent. All told, over $2.1 trillion in private securities backed by risky subprime and Alt-A mortgages were issued between 2004 and 2006.

How was it that investors were so willing to invest so much in securities with such poorly underwritten loans? For one thing, the big run-up in home prices postponed the realization of the downside risks in these loans. In addition, as private securities were taking off, the capital markets were also dramatically increasing issues of collateralized debt obligations -- CDOs -- which included the risky subordinate tranches of the private mortgage securities. CDO issuance related to structured finance increased almost nine-fold between 2003 and 2006 to over $300 billion a year.

These complex, opaque CDO deals obscured and spread the risks associated with subprime and Alt-A securities, but they certainly did not make the risk go away. By the summer of 2007, the capital markets began to realize the extent of these risks and the flaws in the securitization structures that had spawned them.

Foreign money also flooded in, helping keep mortgage rates low and deal-flow high. Between 2004 and 2007, foreign holdings of U.S. agency debt almost doubled to over $1.4 trillion, while foreign holdings of U.S. asset-backed securities more than tripled to just over $900 billion.

Flaws in Private Securitization Structures

We come now to the crux of the matter. Ordinarily you expect long-term investors to carefully scrutinize the securities they buy. However, in this episode, market discipline was tossed to the wind.

There were at least four reasons for this. For starters, as I have mentioned, all these investments performed marvelously as long as home prices continued rising. But prices stopped rising in the spring of 2006, and then fell by one-third over the next three years.

Second, the senior position of many investors led them to believe that they were shielded from all risk of loss. Normally they might well have been right. But in this case, they significantly underestimated the odds of big losses that could affect even their senior securities.

Third, the substantial risks associated with junior positions in subprime and Alt-A securitizations were obscured because they were packaged in complex CDO structures.

And, finally, many of these securities and CDOs were given overly optimistic agency ratings. Many investors relied too heavily on these ratings and failed to do their own due diligence.

This is where the story reconnects with loan underwriting. Had those MBS and CDO investors not been so passive, they would have pulled away and imposed the market discipline needed to uphold best practices at the front end of these deals, when the loans were made. The lack of market discipline also relates to a near-complete divergence in financial incentives between the originators and deal underwriters, on the one hand, and the investors on the other.

In contrast to the long-term payoffs that are expected by investors, many other parties – from the mortgage brokers, to the lenders, to the securities underwriters, to the ratings agencies – got paid upfront. This divergence of financial interests, and the lack of market discipline that it created, explains why loan originators failed to apply appropriate underwriting standards in the first place.

It also explains why trillions of dollars in faulty mortgage paper was issued before the home price bubble finally collapsed.

Restoring Confidence in U.S. Mortgage Finance

This pervasive breakdown in financial practices at the peak of the housing bubble points to the need for fundamental reforms in mortgage finance. But it is simplistic to believe that all of this can be legislated by fiat from Washington, D.C.

While regulation is necessary to set the ground rules and protect consumers, excessively proscriptive rules are likely to either stifle the initiative of the market or be circumvented by new practices. Instead, we need a whole new set of basic ground rules that go from origination, to securitization, to the servicing of the loans. These rules should create the transparency and incentives needed for this market to do what competitive markets do best – efficiently allocate resources and price risks.

We need to have some basic underwriting guidelines that apply to mortgages originated not just by FDIC-insured depository institutions, which are already heavily regulated, but also for the thousands of mortgage brokers who fall outside the rules for banks and thrifts. Basic limits on loan-to-value and debt-to-income ratios, and consistent documentation requirements should be set for any loans held by a depository institution or sold to a securitization trust. Equally important will be to have higher, more consistent standards for consumer disclosures and for ensuring that the loan serves the long-term interests of the borrower.

We also need to strike a balance. We want to prevent the most egregious abuses. But at the same time we don't want to stifle useful innovation and prudent judgment by responsible lenders. By reforming the securitization process, aligning financial incentives, and making deals more transparent, investors can and will impose the market discipline that's been sorely lacking.

The FDIC has taken a lead role in establishing new baseline requirements for structuring securitization deals by updating its rules governing the treatment of securitized assets of failed banks that have been placed into FDIC receivership. These "safe harbor" rules impose a number of common-sense requirements in order for securitized assets to receive sale treatment in a receivership, including: Simpler and more transparent structures; loan-level disclosures, with an adequate due-diligence period and data updates throughout the term of the deal; compensation tied to performance; and origination standards and some retention of an interest in the deal by the sponsor of the securitization.

We see our efforts as complementary to similar efforts underway at the SEC and new rules under consideration as part of the financial reform package being finalized in Congress.

Reforming the GSEs

Since the 1930s, the federal government has played a major role in facilitating the development of a strong secondary market for mortgage loans. Through the Federal

Housing Administration and the government-sponsored enterprises, the government has directly or indirectly provided credit guarantees that have promoted the origination and securitization of mortgage loans that conform to certain standards and size limits.

While these programs have long served to lower the cost of mortgage credit to broad classes of homeowners, they have become an even more essential source of mortgage credit during the recent crisis. In 2009, the FHA and the GSEs accounted for 95 percent of total U.S. mortgage originations.

To the extent that the government wishes to promote homeownership and stability in the availability of mortgage finance, some level of ongoing government involvement is certainly justified. However, a lesson of the mortgage crisis is that any such program must be much more definitive about where the financial obligation of taxpayers begins and ends.

For decades, the mortgage GSEs raised funds in global markets at preferred, near-government rates on the basis of their quasi-governmental status. For many years, this arrangement lowered the cost of mortgage credit to millions of homeowners without adding to the federal debt. However, in the aftermath of the mortgage credit crisis and the conservatorship of Freddie Mac and Fannie Mae, the implicit backing of these entities is now an explicit cost. Federal subsidies for the GSEs in 2009 and 2010 are estimated at over $300 billion.

In banking, the implicit backing of large financial institutions under the doctrine of Too Big to Fail led to moral hazard and excessive risk taking. This is a problem that Congress is attempting to fix. In the wake of the financial crisis, the U.S. and other governments around the world are feeling the brunt of a wide range of "implicit liabilities" that are quickly becoming explicit obligations in times of financial distress.

Our future financial stability demands that we deal with these implicit liabilities head on, and limit the ability of private companies to take risks at the expense of the taxpayer. In the case of the mortgage GSEs, there are a variety of options for making some of their functions governmental while putting others in private hands. But what we cannot do is perpetuate their quasi-governmental status, which privatizes gains and socializes losses.

After the financial reform package becomes law, GSE reform should rise to the top of the agenda. The goal must be to clarify once and for all which functions should be governmental, and which are strictly subject to the discipline of the marketplace.

Restoring Balance to Our Economy and to Housing Policy

I've often spoken of the need, in the wake of the financial crisis, to restore balance to our economy and to our national economic policies. The mortgage crisis in many ways is the culmination of a decades-long process by which our national policies have distorted economic activity away from savings and toward consumption; away from investment in our industrial base and public infrastructure and toward housing; away from the real sectors of our economy and toward the financial sector.

No single policy is responsible for these distortions, and no one reform can restore balance to our economy. We need to look at national policies with a long-term view, and ask whether they will create the incentives that will lead to improved and sustainable standards of living for our citizens.

Homeownership is certainly a worthy national goal. But does it make sense for the federal government to subsidize homeownership in an amount three times greater than the subsidy to rental housing? In the end, these subsidies have helped to promote homeownership, but have failed to deliver long-term prosperity.

I am not advocating a specific proposal. I'm only pointing out that where homeownership was once regarded as a tool for building household wealth, in the crisis it has instead consumed the wealth of many households. Foreclosures continue to take place at a rate of about two-and-a-half million per year, and an estimated 11 million households owe more on their mortgage than their home is worth.

Now, much concern has been expressed in recent weeks that the financial reform legislation will hurt our economy by limiting the earnings capacity of the financial services industry. And if that means limiting the ability to expand private-sector profits by imposing risks on the public balance sheet, they may well be right. But let's put this in perspective.

Any potential harm to the industry's future earnings potential must be weighed against both the long-term increase we have seen in the financial sector's share of U.S. corporate profits and the widely-shared and long-lasting costs of the financial crisis. Whereas the financial sector claimed less than 15 percent of total U.S. corporate profits in the 1950s and 1960s, its share grew to 25 percent in the 1990s and 34 percent in the most recent decade through 2008.

The financial crisis and the Great Recession it spawned threw 8 million people out of work, reduced our GDP by about 3 percent, caused a huge increase in federal debt, and virtually wiped out the entire net income of FDIC-insured institutions for at least a two-year period.

We need to get back to a world where our financial sector supports the functioning of our economy, and not the other way around. And we need to fix what caused the crisis by reforming our mortgage lending and securitization practices. Only by getting back to basics in these most fundamental areas of our financial system can we begin to restore balance to our broader economy and confidence in our economic future. Thank you.