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Federal Deposit Insurance Corporation
Housing Trends and the Economy: Implications for Financial Institutions
America's Community Bankers
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Good morning.

I am glad to be here in San Francisco with you. As far as I am concerned, this city has only one drawback: it's hard to leave. It's a place where, as John Updike said, "the view is visible from anywhere." It's a lovely city.

I want to talk this morning about backbone. Specifically, about how the housing market has been the backbone of the economy during this downturn and how community banks played a vital role in providing consumer financing to keep that market strong. Also, I would like to highlight a few supervisory issues that we at the FDIC are watching.

But first I want to talk a little about the industry as a whole, and where it is today.

It's a fact that the banking industry in 2002 looks a lot different than it did 20 years ago. Changes taking place throughout our entire economy are reflected in the financial services industry - including the powerful combination of long-term trends like deregulation, rapid advances in technology, consolidation, and a strong focus on the consumer.

We have seen an unprecedented consolidation in the industry, resulting in the concentration of assets in a few very large and complex banking firms. In fact, today the combined assets of the three largest institutions in the country exceed the combined assets of all community banks with less than $1 billion.

Despite this powerful trend, there is another story that all of you know very well. Community banks continue to play an important role in their local economies all across America. Certainly investors think so. New charters are up, and community banks overall show better capitalization. Our examiners see less drain on revenue from loan-loss provisions and increased noninterest income - all signs of good health.

Part of the important role community banks play is in financing home mortgages - or, as we so often hear, financing the American dream. And that is what I want to spend some time on today.

Rarely in our history has the housing market been so crucial to the economy. Housing is usually very closely tied to employment and personal income cycles. As a result, it has historically been one of the hardest-hit sectors in a recession.

Yet the experience of the last couple of years has been very different. Productivity gains helped keep personal income relatively strong, and the absence of significant inflation allowed the Federal Reserve to lower interest rates to unprecedented levels - making credit readily available to the vast majority of Americans.

As a result, consumers maintained the ability and incentive to purchase homes. Both new and existing home sales reached record highs. New home sales for September were at an all-time high of over one million units, while existing home sales reached a peak of over six million annualized units earlier this year.

The economy was also fueled by refinancings. Mortgage interest rates have been at or near all-time lows, with the average 30-year fixed rate falling as low as 5.84 percent in the last week of September. The average rate for the first week of October was down more than 60 basis points from the prior year, and was more than 180 basis points lower than rates two years ago.

This low-cost financing made it ever more profitable for homeowners to refinance and secure new terms on their mortgage loans. Last year, seven million homeowners refinanced $1.2 trillion in mortgage debt. That was an all-time high. This year's pace is expected to match or even surpass that record.

Combined with low interest rates, rapid appreciation is adding to the refinancing boom and enabling consumers to extract equity from the homes they refinance. Home prices in 2001 were up about 9 percent on a year-over-year basis and are continuing to climb. This helps explain why cash-out refinancings comprised the majority of all refinancings last year.

It is hard to overestimate how important this was to the overall economy. As the corporate sector has struggled to work off debt overhang, repair balance sheets and restructure business models, the American consumer kept GDP growing over much of the last year. The consumer was supported in this endeavor by strong growth in real disposable incomes - almost half of which was a direct result of the drop in inflation.

The home equity extraction provided consumers with an estimated $90 billion in extra cash last year, and $50 billion in the first half of 2002. Cash-outs have been an important source of funding for today's economy, with the monies going to finance new consumer spending and repay higher cost debt.

It's important to remember that this recent housing performance deviates significantly from historical patterns, and this has led some folks to map out a series of doom-and-gloom scenarios. We've read some analysts' predictions that point to an overheated real estate market whose bubble is waiting to burst. Others caution that consumers are overburdened, and any negative economic shock could stress the sector so much that it triggers a contraction in spending and depresses the housing market. Still others predict that if mortgage rates climb to 7 percent, the housing market will be substantially dampened, leaving refinancing activity no longer able to support consumer finances.

It is important to hear these arguments and it is part of our job to map out these scenarios and attempt to understand their impact on banks. But it seems to us that these theories fail to take into account other important factors. It is important to remember that, while consumers may be more indebted, it is largely a consequence of several very positive trends. These include higher homeownership rates, shifts from renting to owning, and more access to ownership through smaller down payment requirements. This broadening of credit ensures the better allocation of capital - and this is one of the basic functions of the free-market economy.

Also, recent trends have seen the type of debt move from high-cost revolving loans to low-cost, tax-advantaged mortgage debt. Overall, there are many indicators that help refute the idea of an imminent collapse in the housing and consumer sectors. With that said, we need to keep a watchful eye on the housing trends, so that we are not caught off guard by unanticipated events in this sector. You all learned many lessons from the last crisis in the real estate market. Better vigilance of these indicators is a lesson we learned - on the regulatory side of the table - and we'll continue to let you know what we're seeing.

But, as you all know, while it is important to see what is happening, it is also important to know why it is happening. Today, mortgage lenders are able to offer a greater variety of programs and more competitive rates, as well as extend credit to segments of the population that were not served before. You in this room can be justifiably proud of the role you have played in helping countless Americans achieve that dream of owning a home of their own. Indeed, I believe we will be seeing profound consequences from the democratization of credit that has occurred in America over the last 10 years - for regulators, for consumers, and for the financial services industry. This was truly a profound shift - and overall a very positive one for our economy.

But whenever innovations on this scale occur, there are side effects that can cause some trouble. We've seen many lending programs that are so new that they were untested in times of economic distress. Subprime lending comes to mind. And, in some cases, the story is not yet told. The performance of the newest borrowers, for example, who would not otherwise have had access to credit, is especially uncertain.

Another troubling sign is delinquency and foreclosure rates for Federal Housing Administration (FHA) and Veterans Administration (VA) loans, which have more accommodating standards than conventional mortgage products. These rates rose much more dramatically in recent months than rates for conventional loans.

These and other emerging credit weaknesses highlight the fact that banks are in uncharted territory when it comes to the credit risks associated with the new lending environment that has characterized this business cycle. The atypical behavior of mortgage rates, the housing sector, the refinancing market, and consumer spending through the latest recession makes it more difficult than ever before for lenders to use history as a guide when modeling risk, pricing that risk, and making assumptions about the future.

We've seen this in the Federal Reserve Board's January 2002 Senior Loan Officer Opinion Survey on Bank Lending Practices. We found that subprime loan portfolios were much more likely to perform below expectations than standard portfolios, implying that current credit risk models may not be suitable for the newer, more flexible products. Those who responded to the survey indicated that nearly 41 percent of subprime mortgage portfolios did not perform as well as had been predicted, according to last year's credit risk models, while only 12 percent of standard mortgages failed to meet expectations. Thus, while innovative new loan offerings, including subprime and high loan-to-value products, have certainly helped give consumers new strength and greater options in the face of economic downturn, they also exposed new vulnerabilities and generated new risk-management challenges for today's bankers.

Over the past several years, both subprime lending programs and the troubling problem of predatory lending have been a major focus of the FDIC's and the other regulatory agencies' supervisory efforts. In 1999, we issued joint guidelines on subprime lending in an effort to make the industry aware of our concerns. These guidelines recognized that the higher risks associated with this type of lending may warrant higher capital requirements. Since then, several bank failures -- caused in part by troubled subprime lending and securitization programs -- have highlighted the increased risks associated with this part of the market and strengthened the case for additional capital to support those risks.

We expanded our subprime lending guidance last year. No one questions that responsible subprime lending programs can provide expanded and needed credit access for consumers. Nonetheless, there are risks to the deposit insurance funds here, and examiners were advised to address the elevated risk levels associated with such assets, and assess the strength and adequacy of banks' risk-measurement and management systems.

An important goal of our supervisory efforts has been to better distinguish between subprime lending and predatory lending. This is an important distinction. They are not the same thing. While subprime lending provides credit to underserved borrowers, predatory lending is much more sinister, and it makes sense to spend a minute or two on the subject.

Clearly, a line has been crossed when an institution makes unaffordable loans that are not based on the borrower's ability to repay; refinances loans in order to charge high points and fees; or conceals the true nature of the loan from an unsophisticated borrower by fraud or deception. I like to think of predatory lending as "lending with the intent to claim the collateral or punitive fees" rather than "lending to recover principal plus interest."

Two years ago, the FDIC held forums on predatory lending, identified problems of community bankers and leaders, and recommended some solutions. Today, many in the banking community are looking at best practices in an effort to alter lending programs to eliminate predatory practices. We are examining the settlements that have been in the news recently and are considering whether we need to issue additional supervisory guidance.

This issue, the housing issue, and the impact of the democratization of credit are all terribly important to you and to your business. I can assure you they are of interest to us at the FDIC. We are going to be aggressively following these trends, studying their implications and sharing our knowledge with you.

Last month, I announced the FDIC will be undertaking a major study on the future of banking in America. Over the next 12 months, we will be gathering industry input and the views of the other regulators on a variety of issues, including subprime and predatory lending. Your contribution to this study will be invaluable. Let us hear your views. Let us know what you think about the many issues raised as our economy continues to work its way through a period of profound change. I look forward to working with you as we identify present and emerging issues that will challenge both regulators and the industry over the next decade.

Again, I appreciate your hospitality and the invitation to speak today.

Thank you.

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