The Future of Mortgage Lending

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Introduction

Thank you, Jacqui, for that introduction. Good afternoon. I am happy to have the opportunity to welcome you to the Federal Reserve Bank of Minneapolis and speak with you today. I assumed the role of president at this Reserve Bank long after the launch of the Emerging Markets Homeownership Initiative, but I have heard about your goals, objectives, challenges, and successes from my community development staff. I understand the purpose of this “lunch ‘n’ learn” session today is to encourage dialogue and brainstorming on the next steps for this initiative in light of the recent economic and housing crisis. I thought I would provide some context for the changes in mortgage lending practices that have followed the housing crisis. As always, I am speaking for myself today, and not others in the Federal Reserve System, including the Federal Open Market Committee. I trust that my comments will prove beneficial in your endeavors.

Let’s turn back the clock for a moment to the second half of 2006. At that time, firms and people around the world held a wide array of financial assets that were ultimately backed by U.S. residential land. (Think, for example, of mortgage-backed securities or any asset backed by mortgage-backed securities.) They viewed those assets as being largely free of risk. Investors may have understood that a fall in the value of U.S. land would impose large losses on them. However, they put low odds on such a decline taking place. Rather, they seemed to believe that U.S. land prices would continue to rise at a steady clip.

By the second half of 2007, that belief began to unravel in the face of incoming data. People were beginning to learn the hard way that U.S. land was a risky investment. Now the only question was how risky. The uncertainty about the answer to this question planted the seeds for a global financial panic.

What do I mean by the term “financial panic”? Financial panics are events that blur the line between liquidity and solvency. A firm is solvent if its revenues (in a discounted present value sense) exceed its expenditures. A firm is liquid if it is able to raise enough funds—either by borrowing or by selling assets—to pay its current costs. In a well-functioning financial market, solvent firms are typically liquid, because they are able to borrow against their future profits. In contrast, in a financial panic, lenders feel unable to assess the future profits and/or collateral of borrowers. Borrowing becomes highly constrained, and even highly solvent firms may become illiquid.

During the mid-2000s, many forms of collateral around the world were either implicitly or explicitly backed by U.S. residential land. As I’ve described, beginning in mid-2007, it started to become clear that this asset had more risk than financial markets had originally appreciated. It was not clear, though, how much more risk was involved. As a result, financial markets became increasingly uncertain about how to evaluate assets backed by U.S. land. That uncertainty translated into uncertainty about the ultimate solvency of institutions holding those assets—and the ultimate solvency of any of those institutions’ creditors.

As investors became more concerned about the quality of mortgage loans, the secondary market for private-label mortgage-backed securities nearly disappeared. As a result, about 90 percent of mortgages originated over the past two years were guaranteed by government-controlled entities such as Freddie Mac, Fannie Mae, the Federal Housing Authority, or the Veterans Administration. Investors are willing to purchase mortgages and mortgage-backed securities from these agencies mainly because they have faith that the federal government stands behind those instruments.

This heavy reliance on government guarantees is not a sound long-term strategy. Over time, our country needs a mortgage market that returns to greater reliance on private risk-taking and private risk assessment, along with the enhanced regulatory oversight that is already in place. And, in fact, discussions are currently taking place on suitable options for bringing more private capital back into the mortgage market.

Even more generally, I believe that as a country, we need to take this opportunity to rethink many aspects of our public policy programs in the context of housing finance. Home ownership has long been part of the American dream, in no little part because home owners have invested not just in their houses but in their communities. But, through the mortgage interest tax deduction and other programs, we are encouraging people to buy homes by taking on debt—and sometimes large amounts of debt. If we truly want to encourage home ownership, we should contemplate programs that provide incentives for individuals to save and become *equity* holders in their homes—and, by extension, in their communities.

Conclusion

We have come through a very difficult recession, caused in no little part by the large fall in residential housing prices that took place after 2006. I believe that the size of this shock meant that this recession was going to be a painful and challenging one, regardless of the policy response. Certainly, the Fed has played, and will continue to play, multiple roles in promoting sound, affordable, and accessible housing finance. In our most prominent role as makers of U.S. monetary policy, the Fed is committed to keeping inflation under control, which helps make traditional mortgages more affordable.

The Fed also has a key role in overseeing many of the recent financial reforms aimed at preventing the excessive risk-taking that contributed to soaring home prices, imprudent lending, and ultimately, the housing bust. Our safety and soundness and macro-prudential supervisors will be leaders in applying new regulatory approaches for banks and others.

Finally, as part of our continuing responsibility for implementing the Community Reinvestment Act, our community development unit plans to work with you to develop understanding, institutions, and programs to promote equal access to credit and financial services. I look forward to hearing the results of your discussion groups today, including concrete suggestions for how the Federal Reserve can help via its policies, programs, and research.

Thank you very much.