

U.S. DEPARTMENT OF THE TREASURY

Press Center

Remarks by Secretary Henry M. Paulson, Jr. on U.S. Housing Market before FDIC's Forum on Mortgage Lending to Low and Moderate Income Households

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Washington, DC--Good afternoon. Thank you Chairman Bair for convening this forum, and thanks to all of you for your interest in encouraging responsible lending to low and moderate income households.

As we all know, this is a timely issue as the housing correction and capital markets turmoil has reduced the availability of credit for mortgages and other lending. Men and women who have worked hard and saved in order to own their own home should know that despite pressures, the mortgage market remains open to them. As the late Ned Gramlich often observed, subprime and other low and middle income lending has played a critical role in helping expand homeownership opportunities for these borrowers. Our responsibility is to work through today's issues and do so in a way that preserves and protects responsible mortgage lending to low and middle income families.

U.S. Housing Market

After several years of lax lending standards and rapid home price appreciation, we are going through an inevitable housing correction. The correction began in 2006, and most forecasters expect a prolonged period of adjustment with foreclosures continuing to rise and housing prices continuing to fall. We are working through the excess new home inventory – the inventory of new single family homes is down 21 percent from its 2006 peak. Another sign that we are well into the adjustment process is that existing home sales appear to have flattened over the past several months, indicating that demand may be stabilizing.

Many of the headlines of falling national home prices are alarming. While prices are undoubtedly declining, the true picture of what homeowners are facing on the ground is varied and cannot be captured in a single national number.

We need to recognize that there is not a national housing market, but a collection of regional markets. Although home prices nationwide experienced rapid price appreciation, price increases were especially pronounced in a few regions. For example, house prices in California, Florida, Arizona and Nevada more than doubled between 2000 and 2006. Similarly, the severity of the current correction varies widely by state and region. These four states, which have 25 percent of all U.S. mortgages, accounted for 42 percent of foreclosure starts in the first quarter of this year, and almost 90 percent of the increase in foreclosure starts. When we add Indiana, Michigan and Ohio, states facing economic challenges, to the aforementioned four states, these seven states comprise 33 percent of mortgages and over 50 percent of foreclosure starts in the first quarter. Foreclosure starts in these states are up 300 percent over the past two years. Of course, that does not mean the correction isn't being felt everywhere; even in the other 43 states, foreclosure starts are up about 90 percent since early 2006. OFHEO's home price data does show, however, that in about one half of the states, home prices actually rose in the first quarter of this year.

In addition, even within a city, home price patterns can be more complex than a single number suggests. We know that foreclosure sales are making up a larger share of total sales than is typical. We also know that foreclosure sales usually occur at a discount to regular home sales. And reported average home sales price is a mix of foreclosure prices and more normal sales prices. Consequently, the prices homeowners realize when selling their home may not be as depressed as the headlines suggest. For example: data from Radar Logic show that in Los Angeles, foreclosure sales in March 2008 were 29 percent of total sales, up from 3 percent in March 2007. In fact, data from this source also show that through March of this year, foreclosure sale prices fell 11 percent in Los Angeles while prices of other homes sold fell 2 percent. This is not intended to minimize what homeowners are experiencing; rather, looking behind the statistics gives us a better understanding of what is really happening.

Beginning last summer, we have implemented a series of public and private initiatives to help struggling homeowners, while also working to minimize the impact of the housing correction, without impeding its necessary progress. The sooner we get through this correction, the sooner we will see home values stabilize, more buyers will return to the housing market and housing will again contribute to economic growth.

In the simplest of terms, the housing market is being negatively impacted by excess inventory and a reduction in the number of homebuyers. These two factors are working in tandem; we cannot reduce the inventory unless we have committed homebuyers. And the availability and price of mortgage financing will affect how many buyers come into the market and when.

There were 1.5 million foreclosures started in all of 2007, and a number of economists now estimate we will see about 2.5 million foreclosures started this year. Even with a strong economy and strong housing market, we saw 800,000 foreclosures started in 2004. Although regrettable, this is normal, and attributable to life events, such as job loss. Public policy cannot be expected to prevent these foreclosures. Many of today's unusually high number of foreclosures are not preventable. Due to the lax credit and underwriting standards of the past years, some people took out mortgages they can't possibly afford and they will lose their homes. There is little public policymakers can, or should, do to compensate for untenable financial decisions. And in the midst of rapid price appreciation, some people bought homes anticipating an immediate profit. Now that their investments have not turned out as they had hoped, these people may walk away, even though they can afford their mortgage payment. These borrowers can and should be living up to their mortgage commitment - government intervention here would be inappropriate. These two categories of foreclosures - stemming from lax underwriting standards and increased speculation - will remain elevated in the near term.

Since last summer, we have been intently focused on avoiding preventable foreclosures: where homeowners, one, want to keep their homes and two, have the financial wherewithal to do so. Here, the challenge we encountered - and it was a big one - was the impending threat of a market failure arising from the complexities and difficulties of a mortgage market that had been transformed by the wide-scale securitization of mortgage financing. Simply put, this impending market failure had the potential to result in many foreclosures that did not make economic sense because it was in the best interest of both the homeowner and the lender to modify the terms of the mortgage so the borrower could stay in the home.

This potential market failure arose from the emergence of the complex originate-to-distribute securitization model where mortgages had been sliced and diced then packaged and sold to investors around the world. The magnitude of the impending correction threatened to overwhelm the normal workout and modification processes in a way that raised a series of technical, legal and accounting issues that likely could not be addressed in a timely fashion by individual market participants working on their own. The result would have been that many borrowers who would otherwise get a modification or refinance would instead go into foreclosure simply because no one could respond to them in time. No responsible homeowner who has been making payments and wants to stay in their home should go into foreclosure merely because the workout system was too busy to find them a solution that is in both the lenders' and the homeowners' best interest.

We sought to address this potential market failure, by working with the industry to facilitate a process that approximates what would be normal behavior between a bank and a struggling borrower if the borrower were dealing with a bank that had originated and held the mortgage. And so last summer, we encouraged the creation of the HOPE NOW Alliance of mortgage lenders, servicers and counselors with the urgent mission of untying the Gordian knot of complexities surrounding the mortgage workout process. In many ways, this has been a race against time. While there have been bumps in the road and there is still work to do, the industry, through HOPE NOW has made an enormous effort and great progress toward meeting these challenges.

HOPE NOW's numerous efforts to help homeowners avoid preventable foreclosures has been successful. HOPE NOW reports that since last July, the industry has helped 1.7 million homeowners with loan workouts that allowed them to stay in their homes. At the current pace, nearly 200,000 additional borrowers are helped every month. This private sector effort has complemented public efforts to avoid preventable foreclosures, including through expanded access to Federal Housing Administration programs, which has enabled more than 250,000 borrowers to refinance into affordable FHA mortgages since last August.

In particular, there are a number of key areas where HOPE NOW is showing substantial progress. Improved outreach strategies have dramatically increased the response rate of troubled borrowers. Industry is more closely coordinating with mortgage counselors, including paying for counseling. The Alliance members get together routinely, to continuously improve efficiency and reduce the time it takes to respond to a borrower who asks for help. Importantly, modifications as a percent of workouts have climbed from 19 percent to 41 percent for all borrowers. For subprime borrowers, this trend has been even more pronounced, going from 17 to 50 percent. While HOPE NOW is aimed at helping all borrowers, several programs are focused specifically at subprime ARMs. In keeping with recent trends, in the first quarter of 2008 these loans accounted for 6 percent of loans outstanding but 37 percent of foreclosures started - that means that a subprime ARM is four times more likely to have entered foreclosure than a prime ARM and 22 times more likely than a prime fixed-rate mortgage.

In December, HOPE NOW announced a new protocol designed to streamline some subprime ARM borrowers into consideration for a refinancing or modification, so that resources are available for more difficult situations. The objective is not to maximize modifications; it is to minimize foreclosures for those subprime ARM borrowers who could afford the starter rate. From the outset of the HOPE NOW process, I have measured success by whether a borrower who has made all the payments at the initial rate, but couldn't afford the reset and reached out for help avoids going into foreclosure. And so far, the data on this question show an unqualified success.

Of course, lower interest rates have significantly reduced the reset problem. Still, there is no question that because industry has acted to fast-track eligible borrowers, we are achieving our objective. Of the more than 700,000 subprime mortgage resets originally scheduled through May of 2008, only 1800 loans that were current at reset have entered foreclosure. We will continue tracking that number closely to monitor progress. Entire industries do not adjust easily or quickly, even when markets are calm. The HOPE NOW Alliance is demonstrating that an industry can, through coordination, make a difference and do so without forcing American taxpayers to pay the bill.

And we are always pushing to do more. For example, second liens have proven to be an impediment to completing loan workouts as negotiations between borrowers, first lien holders and second lien holders have been complex and time consuming. To help address this,

HOPE NOW recently announced guidelines for automatic re-subordination of second liens to enable loan modifications and refinancings to execute more quickly. The American Securitization Forum (ASF) announced today that it would extend its streamlined protocol announced in December to more borrowers than just those experiencing their first rate reset, helping HOPE NOW reach more families. These and other similar efforts will help ensure that the industry as a whole moves together.

Homeowners have responsibility as well. We can't help those who aren't willing to help themselves, and we must continue to urge struggling borrowers that if they haven't already, they need to reach out for help.

Availability of Mortgage Finance

Essential to ending the correction is a return of homebuyers. In many parts of the country a starter home had become unaffordable, and the current correction should bring home prices back within reach for many Americans, so long as financing is available. Those of you here today will have an enormous impact on their ability to get the financing to buy a home.

Two institutions in particular – Fannie Mae and Freddie Mac – have an important role to play. They can be a constructive force in this period of stress in the housing market. I have been strongly encouraging all financial institutions to raise capital so they can continue to finance consumer and business activity that supports our economy. In particular, I am pleased that this spring both GSEs committed to raise more capital. Fannie Mae has raised \$7.4 billion in capital in the last several months, and Freddie Mac has committed to raise additional capital. Fannie Mae and Freddie Mac today touch 70 percent of all new mortgages. Fresh capital will strengthen their balance sheets and allow them to provide additional mortgage capital, as they balance their responsibilities to their mission and to their shareholders during this period of housing market adjustment. The availability of mortgage finance is also supported by the Federal Housing Finance Board's decision to allow the Federal Home Loan Banks to increase their purchases of mortgage securities.

Given the very important role being played by the GSEs today, we are particularly focused on completing work to create a world-class regulator for Fannie Mae, Freddie Mac and the Federal Home Loan Banks. A strengthened regulator for Fannie and Freddie will increase investor confidence in these enterprises and will be a substantial tool to ease the housing downturn and increase the availability of affordable mortgages for Americans who want to buy a new home or refinance their current one. Creating a strong independent regulator will help ensure that the GSEs achieve their mission while operating safely and soundly.

The House and Senate have made good progress on GSE reform. As I have continually emphasized, completing this legislation is the single most powerful step Congress can take this year to help our nation get through this housing correction.

That said, working through this correction is made more challenging by the virtual disappearance of the subprime lending market. In response to excesses, that market has probably changed unalterably – as it must. Clearly, some who took out subprime mortgages never should have been approved for a mortgage in the first place. Practices, such as low or no doc loans, minimal or no down payments and other lax credit practices, are likely, as they should be, a thing of the past. At the same time, we cannot lose sight of the fact that subprime lending gave millions of responsible Americans a chance to borrow, despite a less-than-perfect credit history. We must not lose the benefits of the subprime market as we eliminate its flaws. Your discussions today will be instructive as to what products and standards can reinvigorate this important sector of the market, as we know that subprime lending is vital to bring the dream and economic good of homeownership to millions of Americans. The subprime market will evolve as markets always do, to find better ways to evaluate and manage credit risk.

Today we are also looking more broadly for ways to increase the availability and lower the cost of mortgage financing to accelerate the return of normal homebuying activity. We are working with FDIC, the Federal Reserve, the OCC and the OTS to explore the potential of covered bonds, which is one promising financing vehicle to do just that. Covered bonds provide funding to an issuer, generally a depository institution such as a commercial bank or thrift, through a secured debt instrument collateralized by a pool of residential mortgage loans that remain on the issuer's balance sheet. Interest is paid to investors from the issuer's cash flow. In the event of a default, covered bond investors' primary recourse is the pool of mortgage loans, and secondary recourse is an unsecured claim on the issuer. Covered bonds have been widely used in Europe to finance residential and commercial real estate, and municipal bonds. At the end of 2006 the European covered bond market was over 1.9 trillion Euros.

And, as Treasury seeks to encourage new sources of mortgage funding in the United States, improve underwriting standards and strengthen financial institutions' balance sheets, covered bonds have the potential to serve these purposes and reduce the costs for first-time home buyers, and for existing homeowners to refinance.

We are also strengthening efforts to improve financial literacy, so that borrowers better understand sophisticated lending products and the obligations they carry. Through the President's Advisory Council on Financial Literacy, Treasury is identifying approaches to financial education that will help potential borrowers evaluate mortgage options and avoid commitments they cannot meet.

Conclusion

The subprime mortgage turmoil has also revealed broader financial regulatory issues, and we are working to address these on a number of fronts, including modernizing the U.S. financial regulatory structure to better match our modern financial system. Treasury released its recommendations for reform last March, and we look forward to working with all interested parties – the Congress, regulators and market

participants – to develop and put in place a better regulatory structure as we work toward an optimal one that hopefully will foster continued progress in mortgage financing while avoiding some of the problems and excesses of the past. Thank you.