Remarks by

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"The Need for Minimum Mortgage Underwriting Standards"

I am very pleased to be here in Tokyo today to discuss some of the important issues facing bank regulators in the United States and around the world. And it is especially nice to be in Japan only a few weeks after an event that showed just how much we have in common – I'm referring, of course, to the stellar World Series performance of Hideki Matsui. As a suffering supporter of my home team, the struggling Washington Nationals, I'm no great fan of the New York Yankees. But fortunately you don't have to be to marvel at the stunning clutch hitting of Mr. Matsui, with his World Series record six runs batted in during the decisive sixth game. Except perhaps in Philadelphia, he thrilled baseball fans all over the world.

Turning to banking issues, it is impossible to talk about any financial topic now without putting it in the context of the financial crisis that has swept the globe. I like to think of the extraordinarily stressful events of the last two years as having three distinct phases. The first was the ***liquidity panic phase***, which appeared to begin with a market event that seemed relatively smaller and contained when it surfaced: sharp losses in the market prices of securities backed by subprime mortgages. In reality, however, the seeds for this market event began much earlier when the subprime mortgages were first made to borrowers. The underwriting practices that lenders used in extending these loans were exceptionally poor – a stubborn fact that I will return to later in my remarks – and it was only a matter of time before significant delinquencies and losses would ensue. That they did, effectively popping the bubble in house prices and setting off a chain reaction of securities losses and steep market declines. That in turn created a pervasive climate of contagion and fear, capital hoarding, and sharp runs on liquidity. Governments around the world were forced to respond with massive and ultimately successful interventions to restore confidence. This was by far the most frightening phase of the crisis, but thankfully, it seems to be largely at an end.

Next came the ***credit loss phase.*** In this stage of the crisis, financial market disruptions translated into problems in the real economy, producing a severe global recession and growing losses in nearly every class of credit extended by U.S. banks – mortgages, credit cards, leveraged loans, and commercial real estate loans, among them. These credit losses have burned through earnings and forced banks to raise substantial amounts of capital and build substantial amounts of loan loss reserves. They have also caused nearly 150 smaller banks in the United States to fail. Unfortunately, we're still in the middle of this phase – perhaps farther along in the cycle of consumer credit losses, but still early on in the losses we face on commercial real estate loans.

Finally, we've entered the ***reform phase*** of the crisis, where governments around the world, individually and collectively, are taking steps to try to ensure that the severe problems we've experienced never happen again. Here, despite a tremendous amount of initial work, we are still very much at the beginning, with few permanent reforms having been adopted by individual countries or international groups. It is on this reform phase – especially as it relates to the shoddy mortgage underwriting practices where so much of the problem began – where I want to focus my remarks today.

A number of international groups of supervisors and policymakers have been deeply enmeshed in developing credible policy reforms to address the crisis. I have had the pleasure of working with my able colleagues from Japan on three of these groups: the Financial Stability Board, the Basel Committee on Banking Supervision, and the Joint Forum. This last group, which I chair, brings together banking, securities, and insurance supervisors from different countries to address issues that cut across all three sectors.

All of these international groups are tackling a range of reforms in such areas as capital, liquidity, credit rating agencies, securitization, credit default swaps, systemic risk, and many others. And in my own country, we are in the process of addressing these very same issues through both legislation and new regulations, while at the same time taking on the daunting challenge of reforming and consolidating our complex system of multiple regulators.

Yet it's striking that, despite all of the hard and very fine work that is being done around the world on these very difficult regulatory issues, relatively little attention has been paid to the initial problem that sparked the crisis: the exceptionally weak, and ultimately disastrous, mortgage underwriting practices accepted by lenders and investors – primarily but not exclusively in the United States. Among the worst of these practices were the following:

- The failure to verify borrower representations about income and financial assets – the infamous "stated income" or "low documentation" loans;

- The failure to require meaningful borrower equity in homes in the form of real down payments, resulting in very high "all-in" loan-to-value ratios;
- The toleration of very high debt-to-income ratios, or similar indications of obvious strain in borrowers' capacity to make regular loan payments;
- The qualification of borrowers for so-called "nontraditional" mortgages based on their ability to afford artificially low initial monthly payments, and not on their ability to afford the much higher monthly payments that would come later;
- And the explicit or implicit reliance on future house price appreciation as the primary source of repayment, either through refinancing or sale.

In addition, many states barred lenders from personal recourse to borrowers in the event of losses exceeding the value of the underlying home, which made it easier for borrowers to take out mortgages they could walk away from if the value of their property dropped too much.

Stepping back and looking at these practices – either individually but especially as a whole – it's simply hard to believe how far and how fast mortgage originators strayed from basic, fundamental, common-sense principles of sound underwriting. And perhaps it's even more astounding that lenders, investors, and yes, regulators, allowed this to happen.

The fact is that, when it came to mortgage credit at the beginning of the 21st century, we in America fundamentally lost our way. The consequences were disastrous not just for borrowers and financial institutions in the United States, but also for investors all over the world due to the transmission mechanism of securitization.

This leads me to two important questions. First, how in the world did this happen? Let me begin my answer with an important contextual observation. For many, many years, home ownership has been a policy priority in America, just as it has been in many other countries. As a result, when times are good, we as a nation have an unfortunate tendency to tolerate looser loan underwriting practices – sometimes even turning a blind eye to them – if they make it easier for more people to buy their own homes. Against that backdrop, an unhappy confluence of factors and market trends created a major problem – a perfect storm, if you will.

Around the world, low interest rates and excess liquidity spurred investors to chase yields, and U.S. mortgage-backed securities offered higher yields on historically safe investments. Hungry investors tolerated increased risk in order to get those higher yields, especially from securities backed by subprime mortgages, where yields were highest. The resulting strong investor demand for mortgages translated into weak underwriting standards to increase supply.

Structured mortgage-backed securities, especially complex collateralized debt obligations, were poorly understood. They gave credit rating agencies and investors a false sense of security that, no matter how poor the underwriting of the underlying mortgages, the risk could be adequately mitigated through geographic and product diversification, sufficient credit tranching, and other financial engineering.

Cheap credit and easy underwriting helped qualify more consumers for mortgages, which increased demand for houses, which increased house prices. That in turn made it easier for lenders and investors to rely more on house price appreciation and less on consumer creditworthiness as the ultimate source of repayment for the underlying loans – so long as house prices kept rising.

In addition, many mortgage brokers and originators sold mortgages directly to securitizers. They therefore had no economic risk when considering the loan applications of even very risky borrowers. In the United States, we sometimes refer to this lack of economic risk as failing to have "skin in the game," a gambling expression describing money at risk of loss. Without any "skin in the game," brokers and originators had every incentive to apply the weakest underwriting standards that would produce the most mortgages that could be sold. And unlike banks, most mortgage brokers in the United States were virtually unregulated, so there was no regulatory or supervisory check on imprudent underwriting practices.

The rapid increase in market share by these unregulated brokers and originators put pressure on regulated banks to lower their underwriting standards, which they did, but not nearly to the same extent as was true for unregulated mortgage lenders. Indeed, from my very first days on the job as Comptroller more than four years ago, we worked hard to keep the national banks we supervise from engaging in the same risky underwriting practices as their nonbank competitors. That made a difference, but not enough for the whole mortgage system.

The combination of all the factors I have just described produced, on a nationwide scale, the worst underwritten mortgages in our history. When house prices finally stopped rising, borrowers could not refinance their way out of financial difficulty. And not long after, we began to see the record levels of delinquency, default, foreclosures, and declining house prices that have plagued the United States for the last two years.

That leads me to my second and more important question: how do we fix the system to stop this from happening again, either in the United States or anywhere else, while still providing adequate mortgage credit to borrowers?

A number of policy recommendations that have been put forward, both in the U.S. and elsewhere, provide credible responses to problems in the mortgage markets that were at heart of the financial crisis. Among the most important are stronger capital requirements for mortgage backed securities and collateralized debt obligations; reform of credit rating agencies; "skin-in-the-game" requirements for mortgage securitizers; and enhanced consumer protection regulation for mortgage products.

All of these would help, but I believe that we need to do more to directly address the core underwriting problems that led to so much misery. And we need to do so in a way that applies equally to <u>all</u> mortgage lenders – bank or nonbank – that operate in a given market. This point is critical: any new mortgage regulation that is adopted must apply to <u>all</u> providers to prevent the kind of competitive inequity and pressure on regulated lenders that eroded safe and sound lending practices in the past.

What I am suggesting here is that regulators establish certain minimum underwriting standards for all home mortgages in a given country – an idea that the U.K. broached recently in a very thoughtful paper on the mortgage market.[1] These would not be "best practices" or even suggested practices that regulators bless as appropriately prudent. Instead, they would be the true minimums that we believe must be observed to keep lenders from risking too much loss to both themselves and their customers. These standards would not dictate every underwriting feature of a mortgage product; instead,

[1] Financial Services Authority Discussion Paper 09/3 Mortgage Market Review October 2009 http://www.fsa.gov.uk/pubs/discussion/dp09_03.pdf

they would focus on core practices of sound underwriting on which there is the broadest consensus.

And, let me add, I am not suggesting that these standards should be the same everywhere in the world. Each country has its own unique credit culture and different approaches to mortgage financing, and what works well in one might not work well in another. What I am suggesting, though, is that each country should articulate what those standards are for their lenders, and should report periodically on how well those standards are working.

What exactly am I talking about? Well, let me use the United States as an example, because that is the market I know best. Here I believe that regulators, with additional legislative authorization as necessary, should establish minimum requirements regarding at least three underwriting practices.

First, underwriters should verify income and assets. Low- and no-documentation mortgages have performed extremely poorly in terms of delinquency, default, and foreclosure. The failure to verify invites misrepresentation and even fraud. It also invites a borrower to assume more debt than he or she can afford. And it materially distorts the integrity of other underwriting practices that depend on accurate measures of a borrower's financial resources, such as debt-to-***income*** ratios. While unverified income might not have been the very worst underwriting practice in the United States – although some would argue it was – it is the one that seems to have the least justification and on which there is the broadest consensus to impose limits. Regulators should consider prohibiting this practice except in very, very limited circumstances where it clearly can be justified.

Second, borrowers should be required to make meaningful down payments. Not too long ago in the United States, the accepted underwriting practice for non-subsidized mortgages was that the value of a mortgage loan could not exceed 80 percent of the value of the house. The borrower had to come up with the remaining 20 percent, and at least half of that 20 percent had to be in the form of cash, with the rest possibly coming from mortgage insurance. The borrower was not permitted to borrow from someone else to get that cash, either – it had to be real equity. Somewhere along the way, the U.S. mortgage market drifted away from this traditional requirement that borrowers put up real money – real equity or real skin-in-the-game – as a condition for obtaining a mortgage. Rising house prices were the likely culprit. They meant that down payments had to be larger in order to meet the 20 percent threshold, and fewer borrowers – especially first-time home buyers – could come up with the increased amount of cash. More important, rising house prices also made it easier for a borrower to repay a mortgage – even a poorly underwritten one – based on the appreciated value of the house. Over time, as prices rose and few borrowers defaulted, lenders and investors began to tolerate "no money down" loans in the form of 100 percent financing, "silent second mortgages," and other types of increased leverage.

The effect has been pernicious: our data show that, without their own equity in homes, borrowers have been much more willing to default and walk away from their mortgages when house prices decline. Accordingly, requiring some minimum amount of real equity in a down payment would be very helpful to restoring credibility to the underwriting process. Of course, it will not be easy to establish exactly what that minimum should be, because too high a requirement could result in many creditworthy borrowers being denied credit. We will need to exercise great care in striking that balance. But just because it's hard doesn't mean we should throw up our hands and avoid establishing a presumptive minimum. Why? Because we know from bitter experience that, whatever the optimum minimum should be, it should not be zero, or so small that we start down the path once again to the problems that brought us to our knees these last two years.

Third, a borrower should not be eligible for a mortgage where monthly payments increase over time unless the borrower can afford the later, higher payments. Too many "nontraditional" mortgages were structured to lower initial monthly payments to make them affordable, with later monthly payments increasing, sometimes sharply, to payments that were often unaffordable. But in many cases, lenders qualified borrowers based only on the affordability of the lower initial rate, and not the higher later rate. That is the type of underwriting practice that generally should be prohibited, because it often implicitly relies on house price appreciation as the ultimate source of repayment of the loan – and as we have learned all too painfully in the last two years, house prices can certainly go down as well as up. We also should generally prohibit the lowering of monthly payments through so-called "negative amortization" mortgages, which have performed terribly. These mortgages lowered initial monthly payments by allowing borrowers not to pay the full amount of interest due, with the unpaid interest added to the principal balance of the loan. Borrowers should not be allowed to dig deeper into debt with each monthly payment.

Now, I don't mean to suggest that these three basic, common-sense underwriting requirements are the only ones that should be embraced in the United States, because others may be warranted either now or in the future. And again, I am not suggesting that such requirements would necessarily be appropriate for other countries (although they certainly should be considered). But I am suggesting that all countries should look to adopt some basic minimums that suit their own circumstances, and that they should publish and report on the effectiveness of their requirements so that other countries can learn from their experiences.

Indeed, with house prices sharply increasing in recent months in some countries, this seems an apt time for countries around the world to take note. That is one reason why enhanced mortgage underwriting standards are currently under consideration by the Joint Forum, the international group I mentioned at the outset, as one of several areas of recommendations to the Financial Stability Board to address differences and gaps in the regulation of financial services around the world.

Let me conclude by saying that relying on regulators to establish minimum mortgage underwriting practices is not a position I come to easily. I am normally much more comfortable with markets establishing the terms for credit extension by willing lenders to willing borrowers, with supervisors focusing on lenders' ability to manage the credit risks they assume, and on lenders' compliance with consumer protection laws. But sometimes, when underwriting standards get so out of balance that they cause widespread damage to borrowers and lenders alike, it becomes necessary for regulators to act more prescriptively. If ever there was a demonstrated need for such intervention, the searing U.S. mortgage market experience of the last several years fits the bill. We should do all we can to avoid repeating that experience, not just in the United States, but in countries all over the world. I firmly believe that establishing minimum requirements for mortgage underwriting practices would help.

Thank you very much.