Reputation and the Non-Prime Mortgage Market

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My topic this morning is the non-prime mortgage market, which has been in the news on almost a daily basis. Non-prime mortgages are the common denominator in such diverse recent developments as rising household foreclosure rates and collapsing hedge funds. You also may have read some of the news coverage of Federal Reserve Chairman Ben Bernanke's testimony on this topic before Congress earlier this week (Bernanke, 2007a).

Developments in the non-prime mortgage market matter to the Federal Reserve for three main reasons. First, the non-prime mortgage market—with 2006 originations of about one trillion dollars[1]—clearly is large enough to affect aggregate homebuilding activity and consumer spending. Second, the Fed also supervises some banks and most financially oriented holding companies; consistent with those responsibilities, the Fed is monitoring the performance of non-prime mortgage loans carefully for signs of further credit deterioration. Congress has granted the Federal Reserve the authority to define unfair and deceptive acts and practices under several important federal consumer-protection statutes. We take this responsibility seriously, and we are gathering information now to determine what else we should do to modify disclosure and other regulations.

Most of the news, and most of the problems, relate to the highest risk part of the non-prime mortgage market—the subprime market. There have also been some problems in the so-called "Alt-A" market, which lies between prime and subprime. What I am calling the non-prime market covers subprime and Alt-A. There are, of course, a variety of non-prime markets, in auto loans and elsewhere. To streamline the exposition, I will drop the modifier "mortgage," and you can assume I am discussing the mortgage market unless I make specific mention of some other market.

Some of the problems we're seeing in the non-prime market may have been inevitable given the breakneck innovation and growth of recent years, followed by a significant cooling of housing-market activity. Yet it is important that we learn the correct lessons from these problems. In a future housing-market slowdown, we want to avoid repetition of recent problems. We also want to preserve appropriate access to credit by those with impaired credit standing. The subprime market in particular is an immature market—a baby market in age, though not in size—and we want to remember the adage about not discarding the baby with the bathwater.

My premise today is that a lasting improvement in the functioning of the non-prime market is most likely if we correct the fundamental problems that seem to be causing the greatest difficulties, rather than attacking mere symptoms of the problem. To preview my conclusion briefly, I believe the fundamental problems in the non-prime mortgage market amenable to improvement stem from inadequate incentives among some of the parties operating in the market to create and maintain strong reputations for quality and fair-dealing. A solid reputation is a valuable asset for the individual firm, for the economy and society

[1] Non-prime mortgage originations during 2006 consisted of approximately $600 billion of subprime and about $400 billion of Alt-A mortgages. These terms are defined below.

as a whole. This point is not a new one. "My word is my bond" has been the motto of the London Stock Exchange since 1801.

Every long-lived business depends on trust in the marketplace. The firm benefits from a durable business franchise, which is why building trust is important to the firm. The economy is more efficient because market disciplines will tend to reduce shortsighted, opportunistic and ultimately wasteful business practices. A better-functioning market will require lenders who are better informed about borrowers' capacity to service debt and borrowers who are better informed about the commitments they are making. When lenders and borrowers alike understand their commitments and risks, sub-optimal outcomes such as mortgage write-downs and foreclosures are less likely. Society benefits from a more efficient use of its scarce resources.

I'll begin by describing the current non-prime market and providing some basic background on the sector. Next comes a discussion of the role of mortgage brokers and realtors and the reputations they establish. I'll finish with a few comments on the Federal Reserve's oversight role in the non-prime market, including a summary of what initiatives and actions we're undertaking.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments. William R. Emmons, senior economist in the Banking Supervision and Regulation Division, and Rajdeep Sengupta, economist in the Research Division, provided special assistance. I retain full responsibility for errors.

THE NON-PRIME MORTGAGE MARKET: SUBPRIME AND ALT-A SECTORS

Market convention is evolving toward a differentiation between prime and non-prime mortgages, and further to subprime and Alt-A sectors of the non-prime market. Analysts face problems in gathering accurate information about the non-prime mortgage markets. I won't dwell on those here, but my text, which is available on the St. Louis Fed web site, describes these difficulties in greater detail.

According to the federal banking and thrift regulatory agencies, subprime mortgages are those made to borrowers who display, among other characteristics, (i) a previous record of delinquency, foreclosure or bankruptcy, (ii) a low credit score, and/or (iii) a ratio of debt service to income of 50 percent or greater (Office of the Comptroller of the Currency, et al., 2007). An Alt-A mortgage—short for "alternative-A" and also known as "A minus"—is one made to a borrower who might be of prime credit quality but who does not qualify for a prime loan because there is something missing or irregular in the loan application. The borrower's credit record may be incomplete or slightly impaired, or the borrower may be purchasing the property as an investment rather than to live in it (Chomsisengphet and Pennington-Cross, 2006). An application file is deemed incomplete when it is missing certain information, as, for example, when the borrower is unwilling or unable to document income or assets to the lender's satisfaction. An irregular application might be one where the borrower does not have a large enough downpayment to satisfy the lender's standard underwriting criteria for prime credit. Alternatively, the borrower's credit history may be short, perhaps because the borrower is young. Thus, the non-prime mortgage sector consists of mortgages that entail a borrowing household with a B, C or D credit grade, a non-standard or incomplete loan application or credit history, or all of these.

Non-prime mortgages carry interest rates notably higher than those on prime mortgages. For a non-prime fixed-rate mortgage (FRM), the spread over a prime FRM could be several percentage points, depending on the borrower and the loan. For a non-prime adjustable-rate mortgage (ARM), the initial rate could be one-half to one percentage point above a comparable prime ARM initial interest rate, while the fully implemented margin of a non-prime ARM could be two or

three percentage points higher than the margin on a prime ARM, itself likely to be as much as three percentage points.[2]

Higher rates are one, but not the only, important distinguishing characteristic of non-prime loans. High rates are necessary for lenders to make an adequate return on investment when facing relatively high underwriting costs and prospectively high delinquency and default rates. Charging high rates, therefore, reflects cost- and risk-based pricing and can be perfectly consistent with competitive markets. It is important to understand that high rates on non-prime mortgages do not, per se, indicate either a lack of competition or predatory behavior by lenders.

There are several other notable differences between prime and non-prime loans. Prime mortgages are more likely to include a fixed interest rate for the life of the loan as well as automatic funding of, and disbursement from, an escrow account used to pay the homeowner's taxes and insurance obligations. During most periods, a larger fraction of prime mortgage loans are for home purchase than for refinancing, in contrast to the non-prime sector, where refinancing is a more common loan purpose. Non-prime loans typically charge higher up-front fees, are more likely to include prepayment penalties, may accept limited or no documentation of the borrower's income or assets, and may be used by investors rather than by owner-occupiers. Some of these practices in the non-prime market have been responsible for high default rates and it is no doubt true that lenders are much more cautious today than a few years ago in accepting limited documentation.

Another distinguishing feature of the non-prime sector is product innovation. In contrast to the traditional 30-year, fixed-rate, amortizing mortgage that dominates the prime sector, the subprime and Alt-A sectors include a wide variety of adjustable and hybrid interest-rate structures, together with a range of principal-amortization options.[3] Of particular note is the recent popularity of so-called "negatively amortizing" mortgages, such as the "pay-option ARM." The federal banking and thrift supervisory agencies issued guidance in 2006 that described these complex mortgages and provided direction to supervisors and lenders on how best to offer and manage these loans (Office of the Comptroller of the Currency, et al., 2006).

EVOLUTION OF THE NON-PRIME MORTGAGE MARKET

In the prime mortgage market, securitization began around 1970. Packaging mortgages into securities was an important innovation, as it permitted development of a secondary market in mortgages and allowed banks and other mortgage originators to control portfolio risk by selling mortgages into the capital market. In the non-prime market, securitization began in earnest only in the mid-1990s. In part because securitization expertise and distribution networks existed already for prime mortgages, the growth of non-prime securitization has been even more rapid than early developments in the prime sector. It took about 35 years for three quarters of prime mortgage originations to be securitized, but a comparable share may be reached in half the time in the non-prime market (Chomsisengphet and Pennington-Cross, 2006).

Along with an increased volume of credit-related information about households and improvements in credit-risk analysis by lenders, securitization probably is the key factor that supported the burgeoning growth of the non-prime

[2] An ARM margin is the amount by which the borrower's interest rate exceeds the index rate, such as one-year LIBOR.

[3] A so-called hybrid mortgage commences with a fixed rate for a few years and then converts to an adjustable rate for the duration of the mortgage term. For example, a 2/28 hybrid has a fixed rate for two years, after which the rate begins to adjust every six or 12 months with reference to an index rate, such as six-month LIBOR or the one-year Treasury yield. A subprime 2/28 mortgage might carry a 550 basis-point margin, which means that, after the initial two-year "teaser" rate has expired, the fully indexed mortgage rate will be the index rate plus 550 basis points. There may be contractual limits on how quickly the mortgage rate may adjust toward the fully indexed rate, as well as limits on how much the mortgage rate may change during the life of the loan.

mortgage market since the mid-1990s. By opening local non-prime mortgage markets to national and global capital markets, the flow of capital to the sector surged as never before. Rising house prices also played an important role, as borrowers and lenders came to expect healthy gains in the equity that borrowers had in their houses, supporting more aggressive loan-to-value ratios in underwriting both first- and second-lien mortgages. Finally, household incomes have grown relatively rapidly in comparison to the cost of borrowing—especially during the early part of this decade, when economic recovery preceded the gradual upward movement of market interest rates.

One aspect of recent developments was odd and has turned out to be the source of much difficulty in the non-prime market. The steep yield curve during much of the 2002-04 period reflected investor expectations that short-term interest rates would be rising, which they in fact did. Yet, many mortgage-market participants apparently did not anticipate this increase. Of course, I would not expect average homeowners to be able to read the yield curve, but I find it odd that apparently sophisticated investors in non-prime mortgage-backed securities now claim surprise that many non-prime ARM borrowers are facing payment shock because of the increase in short-term interest rates over the past few years. Apparently driven by the prospects of high fee income and substantial spreads on non-prime ARMs, mortgage originators persuaded many relatively unsophisticated borrowers to take out these mortgages; then, investors willingly purchased them when they were securitized. Many of these mortgages are now in default, some of the lenders are bankrupt, and the mortgage-backed securities are trading at deep discounts to face value.

It is important to emphasize that what is odd is not that there was a risk of rising short-term interest rates, as there always is, but that the market clearly expected an increase, as indicated by the shape of the yield curve. This expectation, in turn, was encouraged by the Fed's Open Market Committee. The policy statement issued at the conclusion of the FOMC meeting of May 4, 2004, said that "the Committee believes that policy accommodation can be removed at a pace that is likely to be measured." A similar phrase appeared in subsequent FOMC policy statements until December 2005, when the language was changed slightly to "the Committee judges that some further measured policy firming is likely to be needed." At its next meeting, in January 2006, the language changed from "is likely to be needed" to "may be needed," and somewhat similar language remained in the policy statement through the FOMC meeting in January 2007.

Given these widely held expectations of rising interest rates, it is difficult to avoid the judgment that these ARM loans were poorly underwritten at the outset. It was imprudent for mortgage brokers and lenders to approve borrowers who likely could not service the loans when rates rose, and it is surprising to me that sophisticated capital-market investors willingly purchased securities backed by such poorly underwritten mortgages.

As a number of observers have emphasized, rapid growth of the non-prime sector has broadened access to mortgage credit in recent years. The Federal Reserve's Survey of Consumer Finances provides data on the percentage of families that had some mortgage debt on a primary residence at three-year intervals between 1989 and 2004. Between 1989 and 1995, there was little change in the fraction of families that had a first mortgage in any income group, except for the income group representing the 20 percent of families with the lowest incomes, where the fraction of families with mortgages rose from 7.6 percent to 10.4 percent. Gains for these families continued after 1995, with the fraction of those with mortgages rising to 15.9 percent in 2004. Thus, in a period of only 15 years, from 1989 to 2004, the percentage of families in the lowest income quintile that had mortgages more than doubled.

Between 1995 and 2004, the fraction of families with a mortgage on a primary residence increased notably in all income groups. The largest increases were among families below the highest income quintile, suggesting that access to mortgage credit may have increased most for families that were in the middle and lower parts

Table 1

Incidence of Mortgage Debt on Primary Residence

Percent of families that had some mortgage debt on a primary residence	Family income quintile I Lowest	 II	 III	 IV	 V Highest	All families
1989	7.6	23.4	37.8	56.4	72.1	39.5
1995	10.4	25.9	38.2	59.1	71.4	41.0
2004	15.9	29.5	51.7	65.8	76.5	47.9
Change, 1989-1995	+2.8	+2.5	+0.4	+2.7	–0.8	+1.5
Change, 1995-2004	+5.5	+3.6	+13.5	+6.7	+5.1	+6.9

SOURCE: Survey of Consumer Finances, Board of Governors of the Federal Reserve System.

of the income distribution. The middle-income quintile—those families with incomes between the 40th and the 60th percentiles of the income distribution—is particularly striking. After essentially no increase in the incidence of first mortgages between 1989 and 1995, the fraction increased 13.5 percentage points between 1995 and 2004. This period coincides with the most rapid growth of the non-prime mortgage market, and it is likely that families in lower and middle-income groups were among those receiving non-prime mortgages. Table 1 provides more complete data.

The data just discussed cover all mortgages. Comprehensive, long-term data are not readily available on the share of the non-prime mortgage sector in the total market or its composition. One reason for the lack of good data on the non-prime market is that the terms in common use today—subprime and Alt-A, or borrower grades B, C and D—are not defined precisely or consistently across lenders or across time. Another reason for the lack of a good historical database is that what we now call the non-prime sector was quite small until recently, and thus was easily overlooked. Yet another important reason for the paucity of good data is that these types of mortgages were, until recently, not even offered by depository institutions (banks, thrifts or credit unions) or purchased by Fannie Mae and Freddie Mac, the federally chartered mortgage institutions. Instead, a myriad of smaller and specialized non-depository lenders pioneered the subprime and Alt-A sectors, and regulatory agencies did not require these firms to collect and report data to the same extent as their federally regulated depository-institution counterparts.

Given these disclaimers about the limits of our knowledge, we do know that the total amount of home mortgages outstanding at the end of March 2007 was about $10.4 trillion. It appears that as much as $1.3 trillion of subprime mortgages was outstanding at that time, along with about the same amount of Alt-A mortgages (although different data sources provide somewhat different estimates of this sector). Thus, the subprime and Alt-A segments each represent 13 or 14 percent of the overall mortgage market. These sectors together accounted for only about 10 percent of mortgage originations in 1995 (Chomsisengphet and Pennington-Cross, 2006).

The jumbo sector—comprising mortgages larger than the maximum loan size eligible for purchase by Fannie Mae and Freddie Mac—consisted of perhaps $2.5 trillion in March 2007, while prime, conventional, conforming mortgages comprised the remaining $5 trillion.[4] In terms of

[4] The market shares I cite were estimated by a prominent Wall Street investment firm, while other sources provide somewhat different market shares. The precise numbers are not important for my purposes today.

the number of subprime borrowers, there are about 7.5 million first-lien subprime mortgages outstanding (Bernanke, 2007c), out of a total of more than 50 million first mortgages.

Despite the heterogeneity in the non-prime market, the bottom line is that more people have access to mortgage credit now than ever before. The non-prime market has become very large; it is evolving constantly, and yet remains relatively opaque. Despite its limitations and flaws, the non-prime market has served a large number of borrowers very well.

BROKERS AND REALTORS IN THE NON-PRIME MORTGAGE MARKET

One of the key features of the U.S. mortgage market is the large role played by independent mortgage brokers. Mortgage brokers are licensed and supervised by state, rather than federal, authorities and therefore the industry is not subject to a single, consistent supervisory regime across the nation. The Bureau of Labor Statistics reports that about 136,000 people were employed as "mortgage and non-mortgage loan brokers" in May 2007, up from about 50,000 just ten years ago. While the latest employment figure is down somewhat from its recent peak in early 2006, the sector's cumulative employment growth during recent years remains impressive (see Figure 1).

Mortgage brokers are especially important in the non-prime sector. According to a private research firm's estimates, about 58 percent of all recent residential mortgage loans involved a mortgage broker, up from about 40 percent a decade ago.[5] About 50 percent of prime mortgage transactions involve a broker, but brokers originated around 75 percent of subprime mortgages and about 70 percent of Alt-A loans. Clearly, a non-prime borrower is especially likely to deal with a state-licensed and -supervised mortgage broker.

U.S. mortgage brokers are predominantly small, local firms—precisely the type of entrepreneurial firm that contributes mightily to all segments of the U.S. economy. It is quite plausible that these firms generally are more knowledgeable than larger lenders about local markets and borrowers and perhaps can be more responsive and innovative. The employees of a local mortgage broker are likely to be long-time residents with a stake in the community.

It is clear that a firm operating with little capital investment enjoys some benefits. One could mention the ease of opening up a new business, of increasing or decreasing the scale of operations, and of moving or closing down the business. Operating under a regime of "light-touch" supervision also keeps costs low and enhances flexibility.

But the financial risk of operating with little capital is that shocks to the operating environment—such as recent disruptions in secondary markets for non-prime mortgages—quickly can damage, if not destroy, the business. One of the benefits of financial capital is that it can serve as a "buffer stock" of patient funding that will help a firm survive adverse developments in its market. Clearly, many mortgage brokers are thinly capitalized firms that are facing difficult times now in some markets and segments. Many have already entered bankruptcy and others are likely to follow given the scale of the current mortgage-market downturn. Significant exit from a market sector is not a problem as long as subsequent entry remains relatively easy, as appears to be the case in mortgage broking.

There is reason for concern about this business model, however, when capital is so thin that owners have little to lose if the business ceases operations. If the owners have a significant financial investment in the business, and if this capital cannot be withdrawn easily, then the key to profitability is long-term survival in order to earn returns year after year on the invested capital. The owners always will keep one eye on the immediate prospects for short-term profit and the other eye on future profitability.

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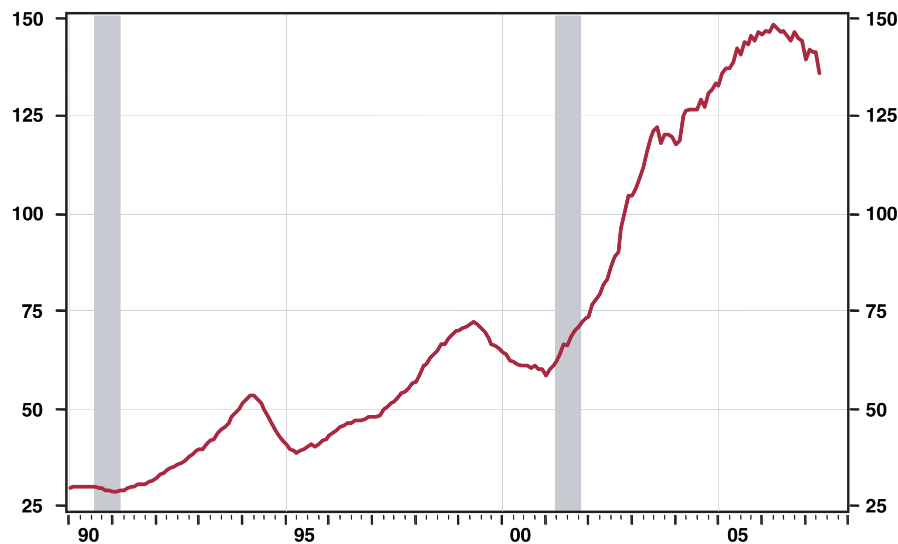
[5] Simon and Hagerty (2007). The research firm whose estimates I cite is Wholesale Access, of Columbia, Maryland.

Figure 1

Employees of Mortgage and Nonmortgage Loan Brokers
Not Seasonally Adjusted, Thousands of Employees



SOURCE: Bureau of Labor Statistics/Haver Analytics.

In the mortgage-banking business, a durable stream of profits requires a continuing flow of customers, both new and repeat business. The business also requires a continuing flow of capital from investors willing to buy the mortgages a mortgage originator wants to sell and securitize. Given the difficulty any mortgage broker likely faces in differentiating its own products, how can a broker stand out from the crowd to become a long-term survivor? One way is to give outstanding service to customers in the mortgage-shopping process. Another way is to stand behind the work the firm does and to be there when a previous customer (or investor) has a question or complaint. Turning these practices into future business prospects, attracting both mortgage borrowers and investors, is precisely the role for reputation.

Advertising may help get out a firm's name, but it is the firm's good name and reputation spread through word of mouth that pays the highest dividends.[6] As former Federal Reserve Chairman Greenspan aptly put it, reputation can be thought of as a valuable asset in its own right:

> Trust as the necessary condition for commerce was particularly evident in freewheeling nineteenth-century America, where reputation became a valued asset…In such an environment, a reputation for honest dealing, which many feared was in short supply, was particularly valued. Even those inclined to be less than scrupulous in their personal dealings had to adhere to a more ethical standard in their market transactions, or they risked being driven out of business (Greenspan, 2005).

[6] I do not mean to suggest that only mortgage brokers would benefit from greater investments in reputation and focus on the long term. Even some large Wall Street firms active in underwriting, trading, and investing in non-prime mortgage-backed securities appear to have hesitated in recent months when asked by some of their counterparties to prove that their reputations are of great value—to demonstrate the old adage in financial markets, "My word is my bond." Given that these firms have large capital investments and that they deal repeatedly with each other, one would have thought that reputation would be sacrosanct.

The non-prime mortgage business may not be as freewheeling as nineteenth-century America, but it has come in for its fair share of criticism recently, to be sure. A reputation for honest dealing surely would be an investment well worth making by many of today's market participants that would pay dividends well into the future—not just for the firms building their reputations, but for all other market participants, as well.

Realtors also have an important responsibility in the mortgage market. From happy experience over the years, I myself know how valuable a realtor can be in providing advice and information on neighborhoods, their schools, quirks of local government and everything else a homeowner should discover before making a commitment to buy a particular house. Realtors can help potential mortgage borrowers shop for mortgages and select mortgage terms appropriate for the individual circumstances of each borrower.

THE FEDERAL RESERVE AND THE NON-PRIME MORTGAGE MARKET

The Federal Reserve had followed developments in housing and the non-prime mortgage markets very closely this year (Bernanke, 2007a, 2007b, 2007c). A highly visible development is the growing amount of financial stress among some of the millions of households with non-prime mortgages. We know that many non-prime mortgage lenders and brokers have gone out of business or tightened their lending standards this year, reducing the flow of mortgage credit to borrowers unable to access the prime market. Financial markets have dealt harshly, but on the whole appropriately, with banks, hedge funds and certain other investors who were heavily exposed to the riskiest segments of the non-prime securitized mortgage market.

While none of these developments is pleasant for the lenders and financial firms most directly affected, one cannot help being impressed with the even-handedness of it all. Until we receive clear evidence that basically sound financial decisions and arrangements were disrupted by erratic and irrational market forces, I believe we should conclude that this year's markets punished mostly bad actors and/or poor lending practices. Lenders who made loans to borrowers without documentation, or who did not check borrower documents that proved fraudulent, or who made adjustable-rate loans to borrowers who could not hope to service the debt when rates adjusted up, deserved financial failure. As is often the case, the market's punishment of unsound financial arrangements has been swift, harsh and without prejudice. While I cannot feel sorry for the lenders who have gone out of business, my attitude is entirely different toward the relatively unsophisticated, but honest, borrowers who have lost their homes through foreclosure. Many are true victims.

Like other observers, we have noted with great concern the increasing delinquency and foreclosure rates on certain non-prime loan categories during 2006 and 2007. Because Congress has assigned to the Federal Reserve and to the Federal Trade Commission the primary responsibility of interpreting and implementing several important consumer-protection statutes, we have been undertaking a number of consumer-protection initiatives and actions.[7] We have been working on revising required credit-card disclosures for several years and, beginning in 2006, we have turned our attention increasingly to non-prime-mortgage issues. I will list briefly some of the more important recent Federal Reserve consumer-protection initiatives related to non-prime mortgages:[8]

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[7] Most notably, the Federal Reserve is responsible for implementing the Truth in Lending Act (TILA, implemented as Regulation Z) and for defining unfair and deceptive acts and practices under and the Home Mortgage Disclosure Act (HMDA, implemented as Regulation C) and its key amendments, the Home Ownership and Equity Protection Act (HOEPA), and under the Federal Trade Commission Act (FTC Act). The Fed's enforcement authority, however, is limited to the financial institutions the Federal Reserve supervises directly.

[8] For more details, see Chairman Bernanke's Congressional testimony (Bernanke, 2007a).

- In coordination with the other federal supervisory agencies, we are encouraging the financial industry to work with borrowers to arrange prudent loan modifications to avoid unnecessary foreclosures.
- Federal Reserve banks around the country are cooperating with community and industry groups that work directly with borrowers having trouble meeting their mortgage obligations.
- We are working with organizations that provide counseling about mortgage products to current and potential homeowners.
- We are meeting with market participants—including lenders, investors, servicers and community groups—to discuss their concerns and to gain information about market developments.
- We are conducting a top-to-bottom review of possible actions we might take to help prevent recurrence of recent problems, including more-effective disclosures to help consumers defend against improper lending.
- We held five public hearings across the country during 2006 and 2007, during which we gathered information on the adequacy of disclosures for mortgages, particularly for nontraditional and adjustable-rate products (see Kroszner, 2007, for more information).
- By the end of the year, we will propose changes to TILA rules to address concerns about mortgage loan advertisements and solicitations that may be incomplete or misleading and to require lenders to provide mortgage disclosures more quickly so that consumers can get the information they need when it is most useful to them.
- We have improved a disclosure that creditors must provide to every applicant for an adjustable-rate mortgage product to explain better the features and risks of these products, such as "payment shock" and rising loan balances.
- We plan to exercise our authority under the Home Ownership and Equity Protection Act (HOEPA) to address specific practices that are unfair or deceptive, including but not limited to pre-payment penalties, the use of escrow accounts for taxes and insurance, stated-income and low-documentation lending, and the evaluation of a borrower's ability to repay.
- In coordination with the other federal supervisory agencies, in 2006, the Fed issued principles-based guidance on nontraditional mortgages, and, in June of 2007, the Fed issued supervisory guidance on subprime lending.
- We reviewed our policies related to the examination of non-bank subsidiaries of bank and financial holding companies for compliance with consumer protection laws and guidance.
- As a result of that review and following discussions with the Office of Thrift Supervision, the Federal Trade Commission and state regulators, as represented by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators, we are launching a cooperative pilot project aimed at expanding consumer protection compliance reviews at selected non-depository lenders with significant subprime mortgage operations.

Based on these activities, I think you will agree that the Federal Reserve takes its consumer-protection responsibilities in the area of non-prime mortgage lending very seriously.

CONCLUDING REMARKS

Every mortgage foreclosure is a tragedy for the borrower, except perhaps those where the borrower participated in a fraud. Yet this observation does not by itself suggest what can or should be done to improve the functioning of the mortgage market. Based on my observation of financial markets, institutions and regulation

over many years, I am convinced that we need to search for ways to strengthen borrower protections without so increasing regulatory costs and risks to lenders that they withdraw from the non-prime market. When we consider regulations designed to address abusive lending practices, we need to understand their possible impact on responsible lenders. We will not be helping potential borrowers if we eliminate abuses by imposing regulations that have the unintended effect of eliminating the entire subprime market. My comment is not a counsel of despair, but a counsel of caution. Regulators need to be creative and not necessarily inactive.

We need to emphasize individual responsibility and accountability in every corner of the market. Lenders and brokers who put naive borrowers into unsuitable mortgages, which later go into default, deserve the losses they suffer. But these lenders and brokers also lose a long-term business opportunity. A successful borrower, who is able to stay current on a subprime mortgage, can expect to become a prime borrower in time. Every mortgage lender or broker should want that borrower to become a repeat customer.

Regulators should do what they can to help educate borrowers and encourage improvements of incentives and business practices. If any of you believe there are ways the Federal Reserve can help in providing information, I hope you will call on us so we can be partners in this endeavor.

Thank you, and I'd be delighted to take your questions.

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APPENDIX

Classifying the Non-Prime Mortgage Market

There are several conceptually distinct approaches to classifying the various segments of the residential mortgage market. The sector classifications sometimes overlap each other, and sometimes they create anomalies of various sorts. This appendix provides a brief introduction to some of the classification schemes used in the mortgage market.

Conventional vs. Non-Conventional. One way to split the market is to distinguish between government-insured or -guaranteed mortgages and the private, or "conventional" sector. The government (non-conventional) sector comprises mortgages made by private lenders but backed by the Federal Housing Administration (FHA) or the Veterans Administration (VA). Government-guaranteed mortgages constitute only about 10 percent of the total market today.[9]

Conforming vs. Non-Conforming. Another way to split the mortgage market is to distinguish between mortgages eligible for purchase by Fannie Mae and Freddie Mac—so-called "conforming" mortgages—and all others ("non-conforming"). The conforming share of the market is perhaps 70 percent in the sense that this fraction of borrowing households could qualify for a mortgage eligible for purchase by Fannie or Freddie if they chose to submit such an application. The actual purchases made by Fannie Mae and Freddie Mac were just over 50 percent of the total market earlier this decade and now are below half. In addition, some conforming mortgages are held by the loan originators or sold to others without the intermediation of Fannie or Freddie.

The conforming market is entirely conventional and prime, but there are conventional and prime mortgages that are not conforming. The non-conforming sector includes "jumbo" mortgages—those larger than the upper limit placed by law on Fannie and Freddie purchases—and others that fail to meet Fannie and Freddie underwriting guidelines for one reason or another. The subprime, Alt-A and jumbo sectors emerged from the conventional, non-conforming part of the mortgage market.

Subprime Mortgage Lenders vs. Prime Lenders. A third mortgage classification scheme is especially important for understanding the subprime sector and federal consumer-protection efforts in this area. The U.S. Department of Housing and Urban Development (HUD) deems all mortgage loans subprime that are made by a lending institution engaged primarily in that business line.[10] While not ideal from an analytical perspective because it lumps together some dissimilar mortgages and borrowers simply because they have a common originator, the HUD classification scheme is extremely important in practical terms.[11] This classification convention is followed both for Home Mortgage Disclosure Act (HMDA) reporting purposes and by the Mortgage Bankers Association when compiling its widely used mortgage-originations and -delinquency surveys.

Subprime Mortgage Products and Practices vs. Prime Products and Practices. A fourth approach to determining what the non-prime market is could be termed a product- and practices-based approach. Some consumer advocates have argued that certain mortgage features, product types or underwriting practices are targeted to vulnerable populations, such as minorities, women, households with irregular incomes and others. These advocates argue that some features, products and practices—such as pre-

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[9] For more information on government mortgage programs, see Quigley (2006).

[10] For details of HUD's methodology and a list of subprime lenders, see the HUD website, http://www.huduser.org/datasets/manu.html.

[11] For more information on HMDA and the Home Ownership and Equity Protection Act amendments to HMDA, see http://stlouisfed.org/hmdaregcamendments/default.html.

payment penalties, hybrid ARMs with introductory teaser rates, underwriting without regard to long-run mortgage affordability and yield-spread premiums paid to brokers by lenders—are deceptive and abusive in their own rights. In other words, the advocates argue that these features, products and practices should be considered per se subprime—if not predatory—and deserving of greater oversight. In this view, some borrowers who could have qualified for a prime mortgage end up with more-expensive subprime or Alt-A loans because they are part of a group that is targeted to receive a non-prime mortgage.