THE MORTGAGE MARKET IN RECOVERY:
SOME SUGGESTIONS FOR A POSSIBLE FUTURE

Remarks of Joseph A. Smith, Jr.
North Carolina Commissioner of Banks

To

Mortgage Outlook 2008 Conference

American Conference Center
New York, New York

November 30, 2007

Thank you very much for inviting me to be with you today. In keeping with the conference's forward-looking approach, I would like to share with you a few thoughts on the future of the residential mortgage market in general and its governance in particular.

First the good news. As a seasoned veteran who has lived through "the death of equities," the S&L debacle, Black Monday and a number of other financial misadventures, I am reasonably certain that financial markets and our economy will survive the current crisis.

Regrettably, there is other news as well. It isn't clear how long the market correction will take and what the cost to the financial system, the economy and homeowners will be. My sense of our current situation is that working through the mortgage market's problems will take years, not days or months, and that the duration and severity of this process will depend on a number of factors, the analysis of which is best left to others. I understand from experts in housing economics that the factors supporting the market's long-term health remain positive that getting from here to there will be a challenge.

As we work through our current difficulties, I hope we will include in our labors changes in the market's operations and governance that will return it to health and create long-term stability. To that end, I would like to make some suggestions about how we can have a better world, at least in respect of housing finance, when the crisis is over.

The better world as I conceive it does not involve a return to an industry structure comprised only of banks and thrifts. Recent events will probably increase the share of the market held by such institutions, but taking brokers, mortgage bankers and capital markets firms out of the mortgage market would be a profoundly bad result from the point of view of consumers. Warts and all, the non-bank players have provided increased liquidity, product innovation and competition. Capital markets have a place in my possible future; they just need a little remodeling.

So, what does a desirable and possible future look like? In my view, it will be based on a proper allocation of responsibilities between government, the financial services industry and consumers. Let me discuss each in order.

It is clear that government will reassert its role in the mortgage market in the future. The issues remaining to be determined are "which government?" and "what role?"

The choices for "which government" are: federal, state or both. At the "federal" end of the spectrum are proposals floated every now and again that a federal "super-regulator" be established or designated to govern the entire market. At the other end of the spectrum of opinion, advocates for states' rights propose a continuation of the *status quo,* coupled with a reversal of the recent

Supreme Court decision in *Watters v. Wachovia.* I don't believe either of these approaches is likely to succeed. Recognizing the political realities and the need for improved supervision, I would suggest a coordinated combination of federal and state resources.

The most desirable future for mortgage market regulation would be for regulatory, supervisory and enforcement activities to be conducted by a network of state and federal authorities, rather than a federal "super regulator" or the continuation of the *status quo*. The problems of the mortgage market are widespread and involve tens of thousands of firms and individuals all over the country. No single agency, federal or state, can police this market alone, unless it is willing to ignore (through the exercise of prosecutorial discretion) predatory and illegal conduct on a small scale. Putting aside legal and constitutional arguments for a moment, there is no good reason in policy to let jurisdictional disputes remove cops from this beat.

Federal and state regulatory agencies are working together now on a variety of matters including AML / BSA, mortgage fraud and consumer protection. This approach can and should be extended to mortgage regulation.

As to "what role" government is to play, three activities are worthy of mention: *setting of standards, licensing and supervision,* and *enforcement*. The network I have just suggested will best be formed as federal and state agencies engage in these activities. Let me discuss each of them.

The setting of standards can involve either express restrictions on loan terms and market conduct *or* the establishment of principles-based standards to be implemented by regulation and enforcement *or* both.

My personal preference is for principles-based standards because such an approach allows for flexibility in response over time and the incorporation of industry standards should any be promulgated. Recent federal and state guidance regarding non-traditional and subprime mortgages point the way to the development of flexible but meaningful standards in the mortgage marketplace.

It is interesting to note that while the principles-based approach is favored as a general matter by capital markets leaders, it is excoriated when actually applied to the mortgage market, witness the current debate over "suitability" standards. I hope that industry opponents of this approach will reconsider their position and participate in the development of workable principles.

Licensing and supervision of mortgage originators and lenders is somewhat less contentious. The debate on licensing currently is about the need to license individual originators and, if so, who is an originator for licensing purposes. The most complete and effective resolution is licensing or registration of individual originators through a centralized and coordinated system. This approach is taken in legislation recently adopted by the U.S. House of Representatives. The good news on this front is that the Conference of State Bank Supervisors and American Association of Residential Mortgage Regulators have developed a platform for state licensing that will begin operation in January of 2008 and which can be adopted by federal agencies to register originators employed by depository institutions or their subsidiaries quickly and at relatively low cost. Implementation of a coordinated licensing and registration system would be a huge advance in policing the market as it would allow for the sharing of information regarding originators and tracking them as they move from banking organizations to “non-banks” and back.

As for supervision, I believe we can look to the long-running partnership between the FDIC, the Federal Reserve, and state bank regulators as a useful model for supervision of the mortgage market.

Coordinated approaches to examination between the state and federal regulators will improve efficiency for the lender, promote consistent regulatory standards, and enable regulators to be more effective.

The current joint pilot examination project between the Federal Reserve, OTS, and a number of states shows that we can and will transcend the silo approach to supervision.

With enforcement, the best of all worlds would allow federal and state authorities to coordinate their efforts based on relatively consistent standards so that enforcement resources are used as effectively as possible. I have been involved in policing the mortgage marketplace for the last five years and, on the basis of that experience, I can tell you with certainty that the crucial issue in most cases is not who has jurisdiction but who has the time, energy and expertise to go after the bad guys. Appropriate federal standards can, I believe, reduce jurisdictional friction between federal and state authorities. This is most likely if federal standards are based on existing state standards. The legislation that has just been adopted by the House of Representatives takes this approach.

In the most desirable of possible futures, federal and state governments will establish – through legislation or regulations or both -- clear rules of the game and conditions to participation in the market and will work together to enforce these rules and conditions in a coordinated and consistent manner.

This will, in turn, enhance the confidence of all stakeholders in the market and will allow the market to function efficiently and fairly. Optimist that I am, I think we can achieve such a future.

A desirable future for the mortgage industry involves more than government, however; the financial services industry has an important role to play as well. In that regard, I am amazed that there has been little or no action by the investment and securities firms that funded (and often originated) over half of the mortgage loans made over the last several years to take responsibility for the health of the mortgage market or play a role in governing it. This is in contrast to the securities industry of which these firms are a part, where "self-regulatory organizations" are a cornerstone of market governance. I realize that the Securities Exchange Act authorizes such self-regulatory organizations and that there is no comparable legislation in the mortgage market, but wonder nonetheless why Wall Street – which has the gold and can make the rules – doesn't seek to play a role in governing the mortgage market. It is not an accident that the state-sponsored licensing system is being done in partnership with FINRA (formerly NASD). We are borrowing from a very successful infrastructure created by the securities industry. All that is missing in our regulatory effort is the industry itself.

In the best of possible futures, the securities firms that fund much of the mortgage market would use their considerable clout to establish standards of education, training and market conduct that would enhance public trust and confidence while reducing the need for governmental intervention.

It seems to me that this is in the long-term best interest of the industry, so I am puzzled as to why securities firms haven't been more forthcoming. It's not too late for them to get out front on market governance, but time is running out.

Finally, consumers have an important role in bringing the mortgage market back to health. While government and the industry can do a lot to remove structural defects in the marketplace, only consumers have the power to use the market responsibly. Recent financial history is not encouraging in this regard. The conduct of borrowers during the recent mortgage boom suggests to me that traditional standards of prudence, thrift and self-control appear to have been wrung out of our society's financial DNA. This lack of financial acuity is as much a cause of our current difficulties as industry misconduct or negligence and it is an impediment to a better future for the mortgage market.

The open question regarding consumers is what can be done to help them play their important role.

One suggestion to improve the capacity of consumers to use financial products and services to their advantage is to increase their financial literacy. While I think this suggestion is questionable as a general proposition, there is support for it in the academic literature and in practice as it relates to achievement of an important goal such as home ownership. Counseling in this context works for a couple of reasons: it prepares borrowers for the burdens of debt and it provides an early warning system with regard to loans that are disadvantageous or predatory. The issue is how to get consumers to avail themselves of independent counseling that confers these benefits. In that regard, I have an idea or two.

My favorite idea combines the findings of behavioral economics with the financial education findings I have just mentioned.[1] It is as follows: normative legislation governing the mortgage market would place upon originators and lenders the obligation to make loans to consumers that are "suitable" to their circumstances. The legislation would define a "suitable" loan to be a thirty-year fixed rate mortgage or such other mortgage as the buyer has selected after a review of the available alternatives with an independent counselor paid for by the borrower. The thirty year fixed rate loan would be the default available to the borrower from which the borrower could opt out but only after counseling. As an alternative, financial counseling could be required for borrowers of all "high cost" or "covered" loans. Required counseling is included in my home state's anti-predatory lending and reverse mortgage statutes. Frankly, this counseling requirement has not been effective because the industry avoided making covered loans, engineered around the requirement or ignored it under preemption principles.

I like the "default / opt out" approach better than required counseling. It encourages borrowers to take out the form of mortgage loan as to which there is the most and richest performance data. This makes it more likely that risk will be appropriately assessed and priced. Purveyors of traditional ARMs, which many argue are the best choice for consumers, will not be unduly hampered, as they will only be

[1] The "default / opt out" proposal set forth in this paragraph is based on the work of Professors Michael Barr of the University of Michigan, Sendhil Mullainathan of Harvard University, and Eldar Shafir of Princeton University, including a paper entitled "Behaviorally Informed Home Mortgage Credit Regulation" presented at "Understanding Consumer Credit: A National Symposium on Expanding Access, Informing Choices, and Protecting Consumers," organized by the Joint Center for Housing Studies of Harvard University and held at Harvard on November 28 and 29, 2007. The papers delivered at this symposium are forthcoming from Brookings Press.

required to have their borrowers counseled before they make such loans. While I expect that the securitization fraternity will hate both of my proposals equally, I would encourage them to think carefully before they oppose them. Counseling is a relatively inexpensive and easy way to prevent headaches in the future.

We are in the middle of a purgation of the mortgage market that may take several more years to complete. The good news, such as it is, is that we will probably muddle through; the other news is that there will be a fair amount of pain and suffering for homeowners, lenders, investors and our financial system in the process. We can grit our teeth and endure this painful period or, if we are wise, we can use it as an opportunity to reform the market and create a better future. I hope very much that we will make the second choice and that my suggestions are helpful in that regard.

Thank you again for your kind invitation and for your attention.