

## **Opening Remarks**

# **The Great Credit Squeeze: How It Happened, How to Prevent Another**

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Good morning and thank you for inviting me to speak.

Let me first say that this new study by Martin Bailey, Douglas Elmendorf, and Bob Litan comes at the right time. It gives a comprehensive overview of how we got to where we are and covers the key issues policymakers must deal with to fix a broken mortgage market and ultimately stabilize housing prices.

Importantly, it connects the dots between some of the seemingly disparate financial developments of the past year. Among these is the direct connection between protecting consumers and safe and sound lending. It's one of the best volumes I've seen since the one written last year by the late Ned Gramlich on subprime lending. As a former academic, I can appreciate all the time and energy that went into it.

Housing crisis

Without a doubt, we have some significant challenges ahead of us. And while some credit markets may be stabilizing families, communities, and the economy continue to suffer.

Frankly, things may get worse before they get better. As regulators, we continue to see a lot of distress out there. Foreclosures keep rising as mortgages reset to higher rates, home prices keep sinking, and millions of families continue to struggle with unaffordable mortgages.

I can sympathize with these families. I've seen hundreds and hundreds of ordinary people at foreclosure workshops desperately looking for ways to keep their homes. And all of us can see the strain on state and local government budgets and the impact on the banking and financial systems.

And there is more uncertainty ahead. Data show there could be a second wave of the more traditional credit stress you see in an economic slowdown. Delinquencies are rising for other types of credit, most notably for construction and development lending, but also for commercial loans and consumer debt.

The slowdown we've seen in the U.S. economy since late last year appears to be directly linked to the housing crisis and the self-reinforcing cycle of defaults and foreclosures putting more downward pressure on the housing market and leading to yet more defaults and foreclosures.

This is why regulators and policymakers continue to focus on the housing market. We need to find better ways to help struggling homeowners.

#### Case for greater government action

Over the past year, federal and state governments, and consumer groups have worked with some success to encourage the industry to modify loans. But it's just not happening fast enough. Given the scale of the problem, this cannot go on loan-by-loan as it has.

Solutions must be simple and practical, and quick to implement. And they must be designed to result in limited or no cost to taxpayers. Congress and the White House are working on proposals that would expand the role of the Federal Housing Administration (which insures mortgages).

These are laudable efforts. They will help certain borrowers. But the FHA approach has its limitations. And new refinancing options may take more time than we have. We need something that is more immediate.

#### Home Ownership Preservation Loans

I think the next line of attack should be using low-cost government loans to help borrowers pay down unaffordable mortgages. We need to take a systematic approach that pays down enough of these mortgages to make them affordable. And it can be done at zero cost to taxpayers.

The FDIC is calling for up to \$50 billion in new government loans that would pay down a portion of the value of over a million existing loans. (The Treasury would sell debt to fund the plan.)

We're calling these new government loans Home Ownership Preservation Loans ... HOP loans for short. Eligible borrowers could get a HOP loan to pay off up to 20 percent of their mortgage.

Mortgage holders would get the cash. As their part of the deal, they would restructure the remaining 80 percent into fixed rate, affordable payments. And they would agree to pay the government's interest for the first five years.

That way, the HOP loans would be interest-free to the borrower for the first five years. After that, borrowers would begin repaying them at fixed Treasury rates.

This would give borrowers a breather, and dramatically reduce the chance of foreclosures.

As another part of the deal, the mortgage holders would agree that the government would be paid first after any sale or refinancing of the house. As a result, taxpayers would be protected from any losses, even if the borrower cannot repay the mortgage for any reason.

The plan would leverage the government's lower borrowing costs to significantly reduce foreclosures with no expansion of contingent liabilities and NO net exposure to taxpayers.


The HOP loan program has a number of major advantages. First, it's NOT a bailout. That's a very big plus.

Second, it would help stabilize a huge number of high-cost mortgages, which would be good for credit markets. And it would also keep people in their homes, and making their payments which would slow the decline in home prices.

HOP loans would essentially give borrowers breathing room by reducing their debt burden to a more manageable level. And they would focus on homeowners who want to stick it out and stay in their homes long-term.

Let me explain how HOP loans would work with a brief example.

Take a look at this projection on the screen.



### Loan Restructuring Example For a \$200,000 Loan

<b>Current Monthly Income</b>	<b>\$3,500</b>
<b>Current Monthly Payment</b>	<b>\$1,744</b>
<b>Initial DTI</b>	<b>50%</b>
<b>After Principal Reduction of \$40,000 and New Fixed Rate of 5.88%</b>	
<b>Years 1 - 5</b>	
<b>New Monthly Payment</b>	<b>\$1,222</b>
<b>DTI</b>	<b>35%</b>
<b>Years 6 - 28</b>	
<b>Monthly payment on treasury loan</b>	<b>\$235</b>
<b>Total Monthly Payment</b>	<b>\$1,457</b>
<b>DTI</b>	<b>39%</b>

For a borrower with a \$200,000 mortgage in this example, the HOP loan program would slash the current payment by about \$500 to \$1,200 a month. (That's a 30 percent reduction.) After five-years, when it's time to repay the Treasury, the HOP loan payment plus the regular mortgage payment would push the monthly total to about \$1,400 a month.

That's still \$300 less a month than the original payment. And it's now five years down the road, giving borrowers time to stabilize their finances and to rebuild some home equity.

There are other advantages. The HOP program focuses on making unaffordable mortgages affordable. And it has incentives for mortgage investors to qualify borrowers who have a good chance of paying-off a restructured loan over the long term.

It would complement the current FHA proposals now before Congress, which may be most effective for people who are deeply underwater with mortgages worth much more than their homes. It also works within existing securitization contracts, avoiding costly legal disputes. Unlike any other current proposal, there would be no need to negotiate with the owners of second-liens, such as a home equity loan.

And it can be implemented quickly because it's administratively simple. In most cases, eligibility can be determined with information readily available from existing records. No property assessments are required.

So, what about the nay sayers?

No matter your political stripes or economic interests, foreclosures, especially preventable ones, are to be avoided. They cost lenders and borrowers a lot of money. A modified, performing loan is almost always of significantly greater value to mortgage investors than a foreclosed home.

As for the taxpayer, as I said, this is no bailout at taxpayer expense. The HOP loan program is designed to result in no cost to the government. The loans and their financing costs would be fully repaid.

What about the speculators?

I was at a foreclosure prevention meeting in Los Angeles a few weeks ago. The place was filled with hundreds of families wanting to fix their mortgages, with hundreds more lined up around the block. I saw a lot of anxious, terrified faces. But I didn't see any loan flippers or condo speculators.

Yes, there are borrowers out there who knowingly overleveraged, hoping to make a quick profit as home prices rose. But there are also many people who were the unknowing subjects of misleading marketing and inexcusably lax underwriting.

All they wanted was to live in a home of their own. What they got was a mortgage they couldn't repay. What's accomplished when these good faith borrowers are forced into foreclosure?

Another empty house on the market. Another blight on a neighborhood. Another hit to surrounding property values. More erosion of local tax bases.

These foreclosures are hurting us all.

Is the HOP loan program the Holy Grail? No. But it could help break the logjam.

Too many unaffordable mortgages are causing a never-ending cycle -- a whirlpool of falling house prices and limited refinancing options that contribute to more defaults, foreclosures and the ballooning of the housing stock. And the only way to break this perilous cycle is by a wholesale restructuring of these unaffordable mortgages.

#### Conclusion

I think it's time we come to grips with the need for more pro-active intervention. And we need to act soon. The housing crisis is now a national problem that requires a national solution. It's no longer confined to states that once had go-go real estate markets. Creating additional tools to help borrowers that are cost neutral and are systematically applied makes too much sense to not act upon.

The FDIC has dealt with this kind of crisis before. Remember the S&L disaster of the 1980s and 1990s? Fortunately, we're in a much stronger position today. Banks are healthy, and we want them to stay that way. But we haven't forgotten the lesson. Not by a long shot.

We learned the hard way that early intervention always costs less and is always better than a policy of after-the-fact clean-up.

I hope that is the path we follow. And I urge all of you here today to climb on board, help us make the right policy choices, and help restore the American promise.

Thank you very much.