Fed Governor Duke urges banks to handle surge of unavoidable foreclosures (February 20, 2009)

Sustainable solutions critical

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In her first speech to a banking group, Federal Reserve Board Governor Elizabeth Duke urged bankers to make reasonable accommodations to at-risk mortgage borrowers, and said that any changes should be sustainable. She also went into considerable detail about ways banks can assist in dealing with the high volume of unavoidable foreclosures.

Governor Duke was sworn in as a Fed Governor last August, becoming immersed immediately in the rapidly unfolding financial crisis. A former community banker who also has large-bank experience, Duke spoke before the American Bankers Association’s National Conference for Community Bankers in Scottsdale, Ariz., Feb. 16. It was her first speech to a banker audience and only her second speech since joining the Federal Reserve Board.

She reviewed the causes of the current weakness in the housing markets and the effects of that weakness, noting that “although the current problems appear to be rooted in high-risk subprime lending, I would like to dispel the notion that these problems were caused in any way by Community Reinvestment Act (CRA) lending…. In our analysis of loan originations, we found that approximately 60% of higher-priced loans went to middle- or higher-income borrowers or neighborhoods, which are populations not targeted by the CRA. Additionally, more than 20% of the higher-priced loans that were extended in low-to-moderate-income areas, or to low-to-moderate-income borrowers, were loans originated by lenders not covered by the CRA.” She added: “Serious delinquency rates for subprime loans are high in all neighborhood-income categories, not only those in lower-income areas.”

As a former community banker, Duke could relate to the frustrations many bankers feel toward the ongoing economic, reputational, and regulatory fallout of a crisis they feel they didn’t contribute to. She acknowledged this but nevertheless urged them to put that aside. “At this moment, we all simply need to do whatever we can to address the enormous challenges facing our communities, including those of us who believe we were being prudent and were not a cause of the difficulty in the first place,” said Duke.

Since joining the Central Bank, Duke has been heavily focused on housing and mortgage finance issues. She serves on the board’s Committee on Supervisory and Regulatory Affairs and chairs the Committee on Consumer and Community Affairs. Like all Fed governors, she is a voting member of the Federal Open Market Committee.

Payments should be fixed for the life of the loan

Much attention has been focused on mortgage borrowers in distress—however that may be defined. Less attention is focused on the large group of borrowers who are successfully paying their mortgages. About that group, Duke said, “One might be tempted to view these households as a lesser concern, but we must be mindful that they will be more likely to shift into one of the distressed groups if we do not reduce both the number of foreclosures and the cost of the foreclosures that do occur.”

In regard to distressed borrowers, Duke told bankers that “while speed and volume in modifications are important, in my view, it is equally essential that the new obligations be sustainable in the long run. By ‘sustainable,’ I mean the payment should be fixed for the life of the loan, it should be affordable, and it should be based upon verified income.” This may require principal reduction as well as a lower interest rate, she said.

Duke spoke two days before President Obama announced his housing rescue plan in a Phoenix suburb. Her comments, which are part of the Homeownership Preservation Policy recently adopted by the Fed Board, were in contrast to one part of the Administration’s plan, which would allow servicers to begin to reinstate higher interest rates after five years.

When foreclosure can’t be prevented

The Fed governor spent a good portion of her speech, however, addressing the impact from foreclosures that cannot be avoided.

“I don’t believe we can fully formulate appropriate policy responses to the crisis unless we acknowledge and address the large numbers of foreclosures that are not avoidable,” she said. “We are likely only beginning to see the serious costs of the foreclosures that have already been initiated…. Even under optimistic assumptions for the number of loan modifications and other forms of private and public assistance that may be realized, the pace at which foreclosures are initiated is likely to remain extremely elevated for some time.”

Duke enumerated some of the efforts currently being used or explored in the public and private sectors to deal with the expanding burden of foreclosed homes, including keeping existing renters in the home or getting new renters—or even the owners—to occupy real estate owned (REO) or vacant properties. There is also some movement at the national level to enable state and local governments and nonprofit organizations to purchase REO inventories from servicers. Nevertheless, she said, lenders and communities are “woefully under-resourced and unprepared for the volume of real estate that will need to be processed.”

One new entity she cited that could help facilitate REO sales is the National Community Stabilization Trust (NCST), formed by four national nonprofit entities. The trust is “trying to create a common platform for services to efficiently sell REO properties to public entities and nonprofit organizations.” Fannie Mae and the Federal Reserve Banks have also been addressing this issue, she said.

“But current efforts are not sufficient to deal with the scale and scope of the problem, and more needs to be done,” said Duke. “…More dollars alone will not solve this problem…. We need to make sure that we are using all of the available public-sector capacity—such as state housing finance agencies and local public housing authorities—that have experience managing affordable rental housing inventories.”

Banks, she continued, can help by minimizing the cost of developing clear policies and procedures for approval of short sales and deeds-in-lieu-of-foreclosure, and should look for ways to partner with community groups and governments to help stabilize communities hit hard by foreclosure. Banks can also help by providing loans to new homebuyers for the reuse of REO properties, she said, and by financing nonprofit groups that can acquire and rehabilitate foreclosed units.

Community banks’ role

Duke concluded her address with this observation:

“As community bankers, you have a long history of engagement in your communities. You have served on the boards of public and nonprofit entities focused on housing. You have built Habitat for Humanity houses, and you have rebuilt entire neighborhoods following natural disasters. Your financial resources will be needed as we work toward solutions for the current crisis, but, even more important, your experience, expertise, contacts, and creativity will be needed. If you believe in the saying that ‘all real estate markets are local,’ you also understand that it will take local knowledge to assess community needs and craft solutions.”

To get started, she recommended contacting local housing nonprofits or the nearest Federal Reserve Bank. Also, she urged bankers to contact municipal authorities or housing counselors, and to “partner with other banks in your market or do it alone. But do it today.” BJ

Read the full speech