

## President's Message



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William Poole

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## Nonprime Mortgage Woes: How We Got There, Where To Go Next

It's been almost a year since the surging nonprime mortgage market hit a brick wall, and still there are headlines almost daily about the reasons, the repercussions and the responsibility for this mess. Amidst the finger-pointing, we should keep a handful of observations in focus so that we don't see this problem repeated under our watch.

First, don't throw out the baby with the bathwater. Although subprime and Alt-A mortgages (which together make up the nonprime market) caused many problems for many people, they have also made it possible for millions of people with less than perfect credit to buy homes. In the 15 years ending in 2004, the percentage of families in the lowest income quintile that had mortgages more than doubled, thanks in no small part to nonprime offerings. This boost in home ownership is a good thing for the economy and society as a whole.

Second, a big part of the problem is due to the relative newness of nonprime mortgages.

They were pioneered by small, nondepository lenders in the early 1990s. They didn't—and still don't—face the regulatory, supervisory or data reporting requirements that depository institutions face. (Only in recent years have mainstream lenders become significant players in these mortgages.) The lack of oversight doesn't necessarily mean these pioneers were destined to rip people

off—remember, entrepreneurs are often the heroes of today's economy. Many lenders had sound underwriting practices. Nevertheless, some of the participants in the nonprime market were thinly capitalized mortgage brokers, nonbank lenders and other investors. Because they had little invested, some took risks that were clearly imprudent, such as approving applicants who had little or no documentation of their income and putting people into adjustable rate mortgages that would be unaffordable once rates increased.

Third, many of the investors who bought securitized nonprime mortgages should have known better. They let their greed blind them to the facts that a significant number of people taking out these mortgages would not be able to keep up the payments if interest rates rose as they were forecast to do. I have sympathy for the borrowers, but not for the hedge funds and other investors who bought bundles of these mortgages as securities.

One of the remedies for nonprime woes is the old-fashioned concept of reputation. Nonprime lenders need to think long-term, not short-term. Do they want that borrower back for his next mortgage? Do they want that investor to return to buy up more mortgages? If the lender/broker thought of return business with the borrower and investor, the net result would be fewer mortgage write-downs and foreclosures.

At the Fed, we are working along with other regulators, such as the Federal Trade Commission, to strengthen consumer protections. We are drafting changes to the Truth in Lending Act regarding ads and solicitations by lenders. We will use the authority we already have to root out unfair and deceptive practices. With other regulators, we are testing the expansion of consumer protection compliance reviews to some nondepository lenders with large nonprime portfolios.

As the Fed and other financial and consumer regulators review existing regulations and study options to strengthen regulations, we must be careful so as not to impose regulatory costs that are so great as to push sound lenders out of the nonprime market. Such an exit would limit credit access to millions of legitimate borrowers and the opportunity for them to achieve the American dream.

*This column is based on a speech given by Poole on July 20, 2007, in St. Louis. To read the full text of "Reputation and the Nonprime Mortgage Market," go to [www.stlouisfed.org/news/speeches/2007/07\\_20\\_07](http://www.stlouisfed.org/news/speeches/2007/07_20_07).*