

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is a darker shade of blue. The hourglass is centered on the page.

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*Securitization and Federal Regulation of Mortgages for Safety
and Soundness*

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October 31, 2008

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Securitization and Federal Regulation of Mortgages for Safety and Soundness

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Summary

Rising defaults in the subprime mortgage market have drawn attention to the regulatory framework for mortgage lending. Traditionally, banks subject to federal regulation have extended loans to potential home buyers and kept the loans in their own portfolios. Alternatively, mortgage lenders can sell their loans to the secondary market, where the loans are transformed into mortgage backed securities (MBS), in a process called securitization. Securitization allows banks and non-banks to offer mortgages without retaining a long-term interest in the loans themselves. Non-bank lenders are often outside the safety and soundness regulation of federal bank examiners, although they are still subject to the consumer protection mandates of the Truth in Lending Act (TILA). The Federal Reserve issued new rules pursuant to TILA for all mortgage loans in July 2008. Federal Reserve implements TILA through Regulation Z.

Guidances issued by the financial regulatory members of the Federal Financial Institutions Examinations Council (FFIEC) help maintain prudent lending standards for covered institutions. Securitization of loans originated by non-banks, however, allows some mortgage lending to escape these guidances. The underwriting standards of Fannie Mae and Freddie Mac, regulated for safety and soundness by the Federal Housing Finance Agency (FHFA), could still influence underwriting standards of non-bank lenders. Caps on the loans they could purchase, and other factors, however, had limited the influence of these government-sponsored-enterprises' (GSE) underwriting standards. These caps were substantially raised (up to \$625,000 in some high-cost areas) by H.R. 3221 / P.L. 110-289.

There is some evidence that the underwriting standards of non-banks that chose to securitize loans outside of Fannie Mae and Freddie Mac became weaker as the housing boom progressed. Indicators of excessive debt appear to have weakened more than indicators of borrower payment history. Potential reforms of securitization and the non-bank lending channel are now under consideration. This report will be updated as conditions change.

Disruptions in the mortgage market have drawn attention to the potential for lenders to engage in imprudent underwriting. During the housing boom of 2002-2005, many borrowers may have become overextended because their loans, in hindsight, were not sustainable. Although federal bank examiners are primarily concerned with the financial stability of the system, one byproduct of their regulations may be to limit the chances that borrowers will be offered imprudent loans by regulated institutions. Securitization, which transforms pools of loans into marketable securities, may have contributed to looser underwriting standards, because it creates a non-bank source of mortgage funds, which is outside federal bank examination.

A non-bank mortgage originator can open a line of credit to fund its lending, rather than accepting deposits or raising its own capital. The originator then draws down the line of credit to make loans. The originator sells the mortgages to the secondary market and uses the proceeds to pay back the line of credit and extends more loans. Once in the secondary market, the mortgages can be packaged together and held in passive trusts. The trusts can then distribute the mortgage payments by a pre-arranged formula to securities, called mortgage-backed securities (MBS), which are purchased by investors. This *securitization* of mortgages increased the supply of funds available for mortgage lending¹, but has also reduced regulation; nothing in the non-bank mortgage originators' activities triggers safety and soundness regulation by traditional federal bank examiners. Although disclosure rules for consumer protection are federally regulated and apply to all loans, the prudence of the lenders' underwriting is disciplined only by the perceived willingness of investors to purchase the loans. This report discusses the network of federal mortgage regulators and the impact of securitization on prudent mortgage underwriting.

Bank Safety and Soundness Regulation and the Limits of Federal Agency Guidance

The United States has a complex financial regulatory structure that varies both by institutional setting and banking function. Federally chartered national banks, for example, are subject to safety and soundness examination by the Office of the Comptroller of the Currency (OCC). Savings associations chartered at both the state and federal level are subject to safety and soundness examination by the Office of Thrift Supervision (OTS). Bank holding companies are subject to safety and soundness regulation by the Federal Reserve (FRB). **Table 1** provides a list of banking institutions and their safety and soundness regulators. The federal banking regulators with examination powers cooperate through the Federal Financial Institutions Examinations Council (FFIEC), which includes the OCC, OTS, FRB, the National Credit Union Administration (NCUA), and the Federal Deposit Insurance Corporation (FDIC).

The agencies of the FFIEC, including the Federal Reserve, issue safety and soundness guidances for their covered institutions, but these guidances do not have the force of regulation on lenders who are not subject to the standards of one of the agencies. For consumer protection, in contrast, the FRB issues binding regulations on all lenders through Regulation Z of the Truth in Lending Act (TILA).² Non-bank mortgage originators using the securitization channel are subject to federal consumer protection regulation, but may escape federal safety and soundness regulation. The FFIEC guidances on real estate lending, subprime lending, and alternative mortgages apply, therefore, to only a portion of the mortgage market.

¹ The decline of housing markets has coincided with a significant decline in securitization.

² TILA is found at 15 USC 1601 et seq, Regulation Z is 12 CFR Part 226.

Table I. Regulators of Banking Institutions

	Charter and License	Safety/Soundness Examination	Consumer Protection
National Banks	OCC	OCC	FRB & OCC
State Member Banks	State	FRB & State	FRB & State
Insured Federal Savings Associations	OTS	OTS	FRB & OTS
Insured State Savings Associations	State	OTS & State	FRB, OTS, & State
FDIC-insured State Nonmember Banks	State	FDIC & State	FRB, FDIC, & State
Non-FDIC-insured State Banks	State	State	FRB, FTC, & State
Federal Credit Unions	NCUA	NCUA	FRB & NCUA
State Credit Unions	State	State	FRB, FTC, & State
Bank Holding Companies	FRB	FRB	FRB & FTC

Source: Table compiled by CRS.

Abbreviations:

- FDIC—Federal Deposit Insurance Corporation
- FRB—Federal Reserve Board
- FTC—Federal Trade Commission
- NCUA—National Credit Union Administration
- OCC—Office of the Comptroller of the Currency
- OTS—Office of Thrift Supervision

During the period 1997-2006, the share of mortgages securitized grew significantly, increasing from 49.2% in 1997 to 67.7% in 2006. In dollar terms, the value of mortgages securitized grew from \$423 billion in 1997 to \$2 trillion in 2006. The growth of this securitization channel may have facilitated more lending by institutions not subject to federal bank examiners, although some of the increase in securitization share came from regulated banks also selling to the secondary market. Private securitization has since collapsed—the volume of non-agency MBS was 93% lower for the first eight months of 2008 compared with the same period in 2007.³

The GSEs and Federal Influence on Non-Bank Underwriting

The absence of federal regulation of non-banks using securitization does not necessarily mean that there is no federal influence on non-bank underwriting. Many mortgages are securitized by government sponsored enterprises (GSEs), especially Fannie Mae and Freddie Mac. Lenders planning on selling their mortgages to the GSEs would have to conform to the underwriting standards of those institutions, which are subject to safety and soundness oversight by the Federal Housing Finance Agency (FHFA), formerly known as the Office of Federal Housing Enterprise Oversight (OFHEO). Standards enforced by FHFA could indirectly influence the willingness of the GSEs' lending partners to extend credit for more risky mortgages.

³ Calculated from monthly MBS issuance available from the Securities Industry and Financial Markets Association (SIFMA), available at http://www.sifma.org/research/pdf/Mortgage_Related_Issuance.pdf.

At least three factors limited the influence of the GSEs' underwriting standards as the housing boom progressed. First, there is a cap on the size of the loan that the GSEs are allowed to purchase, called the conforming loan limit. Loans larger than the cap, ranging from \$417,000 up to \$615,000 in some high-cost areas, are called jumbo loans and can only be securitized outside the GSEs. Securities from issuers other than the GSEs are called non-agency MBS. Because the housing markets in some high-cost areas, such as California, were particularly active during the boom, and mortgages in these areas are more likely to be above the cap, non-agency MBS grew faster than the overall market.

Second, the GSEs did not enter the risky subprime market directly, instead, they purchased the more senior (and therefore less risky) securities of non-agency subprime MBS. A lender planning to sell to a non-agency MBS issuer would be unlikely to alter underwriting standards for GSE purchases of senior securities. One reason the GSEs purchased non-agency subprime MBS was that the Department of Housing and Urban Development's (HUD) housing goals were rising. HUD's housing goals mandate that the GSEs purchase a minimum share of their mortgages for lower-income borrowers and in underserved areas. The GSEs received pro-rated credit toward their housing goals for their share in non-agency MBS. In this way, the GSEs provided additional funds to subprime markets without a corresponding extension of their underwriting standards.

Third, there was a relatively high proportion of refinances during the boom. The decline in interest rates caused a drop in the share of mortgages that were goals-qualifying for GSE purchase. Higher-income home owners disproportionately took advantage of the opportunity to refinance. This meant that relatively large mortgages, which are generally not goals-qualifying, grew as a share of the GSE-eligible market. As a reference, the share of GSE-eligible mortgages that were refinances in the first quarter of 1995 were 26%, but the share of mortgages that were refinances in the first quarter of 2003 were 80%.

Non-Agency MBS and Weakening Underwriting Standards

It is difficult to assess the underwriting standards of non-agency MBS because the information is proprietary. There is some evidence, however, that underwriting standards loosened as the housing boom progressed. The results of one study of the boom, by UBS, are presented in **Table 2**.⁴ The table shows an increase in the average risk of loans underwritten in 2005. For example, interest-only mortgages (I/Os) rose from 0.0% of subprime loans in 2000 to 26.5% of subprime loans in 2005, before falling back to 16.3%. An interest-only requires a reset to a higher payment even if interest rates do not change. Other risk indicators, such as debt-to-income ratio (DTI) and combined-loan-to-value (CLTV), also increased during 2001-2005. Interestingly, the primary indicator of borrower payment history, the FICO⁵ score, improved during 2000-2005 from 590 to 627, although it fell back to 624 in 2006. This suggests that the use of nontraditional products such as I/Os and debt-burdens may have played as important a role as the payment histories of the borrowers. On the other hand, improving economic conditions and rising house prices could generally improve FICO scores and increase the size of loans relative to incomes even if underwriting criteria had not loosened.

⁴ "The U.S. Subprime Market: An Industry in Turmoil," Thomas Zimmerman, UBS presentation, http://www.prmia.org/Chapter_Pages/Data/Files/1471_2576_Zimmerman%20Presentation_presentation.pdf.

⁵ The term FICO comes from scores developed by the Fair Isaacs credit reporting firm.

Table 2. Selected Risk Indicators in Non-Agency Subprime MBS During the Housing Boom

	2000	2001	2002	2003	2004	2005	2006
I/O %	0.0	0.0	0.7	3.7	15.3	26.5	16.3
FICO	590	598	612	621	623	627	624
CLTV	78.1	79.6	80.5	82.0	83.9	85.7	86.0
Full Doc	73.8	72.9	67.5	64.9	62.2	58.3	56.8
DTI	38.6	39.1	39.4	39.7	40.3	41.0	41.8

Source: UBS.

Abbreviations:

I/O%—Percent of loans that are interest-only
 FICO—Average borrower credit score under Fair-Isaacs
 CLTV—Average loan-to-value ratio (combined with any 2nd)
 Full Doc—Percent of loans with full documentation
 DTI—Debt-to-income ratio

Options for Improving Underwriting

Extend Coverage of Agency Guidance

Testimony by the financial regulatory agencies suggests that loans subject to their guidance have fared much better than non-agency MBS originated by non-banks.⁶ On the one hand, the guidances of the FFIEC provided for more prudent underwriting standards and closer scrutiny of subprime loans even before the housing markets cooled off. On the other hand, the guidances are administered by bank examiners within an existing institutional framework and it is unclear how non-bank lenders would be incorporated. Could they be subject to examination by existing agencies and personnel, or would there need to be significant changes to agency structure or staffing?

Do Nothing

The market has already improved underwriting standards and punished the riskiest lenders with bankruptcy and the investors in the riskiest securities with significant losses. Underwriting standards for non-agency MBS were essentially set by the willingness of investors to accept the estimated risk of the mortgage pools. Because investors rarely had detailed knowledge of the loan pools, they often relied on ratings agencies to evaluate the risk. While house prices were rising, a troubled borrower could sell the house rather than default, which held down expected default rates. Because housing markets have slowed down and loan defaults have been rising, markets have been re-evaluating the risks in non-agency MBS. As a result, MBS ratings have been falling, and funding for the riskiest mortgages has already all but dried up. A disadvantage of taking no action is that while the market has already raised current underwriting standards there is no assurance that a future boom and bust cycle will not be repeated.

⁶ Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on Recent Events in the Credit and Mortgage Markets and Possible Implications for U.S. Consumers and the Global Economy before the Financial Services Committee, September 5, 2007.

Originator Liability

Mortgage originators, including brokers and lenders, could be made liable for defaults if underwriting standards are unsuitable for the borrower's circumstances. One advantage of this approach is that originators have direct contact with borrowers and have a great deal of information about each borrower's circumstances, relative to MBS investors or financial regulators. Originator liability could ensure that mortgage brokers and lenders retain a stake in the long-term performance of their loans. A disadvantage of this approach is that suitability is difficult to define, subject to significant uncertainty and litigation risk, and determined only after events occur that trigger defaults.

Assignee Liability

The secondary purchasers of mortgage loans, assignees, could be held liable for unfair, deceptive, or unsuitable mortgage originations. The advantage of this approach is that it would encourage secondary market participants to be more vigilant in monitoring the practices of mortgage brokers and lenders. This approach also gives aggrieved borrowers potential redress if a thinly capitalized mortgage originator goes bankrupt before the borrower can seek compensation. A disadvantage of this approach is that if liability is unclear, investors will not be able to quantify and price it, and the market may shut down.

Set National Underwriting Guidelines in Law

National underwriting guidelines could be set in statute or an agency could be authorized to establish national underwriting guidelines by regulation. Official standards for debt-to-income ratios, FICO scores, and other risk indicators could be announced. Banks, non-banks, and borrowers could all be made aware of a single set of prudential limits on loan terms. On the other hand, mortgage markets would become less flexible and borrowers with nontraditional sources of income or other characteristics would have difficulty qualifying for loans. One such proposal, H.R. 3915, passed the House of Representatives in the 110th Congress but has not as yet been considered by the Senate.

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