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Statement by

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before the

Subcommittee on Telecommunications, Consumer Protection, and Finance

United States House of Representatives

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Mr. Chairman, I appreciate the opportunity to appear before this Subcommittee on behalf of the Federal Reserve Board to discuss Title I of H.R. 4557--the Secondary Mortgage Market Enhancement Act of 1983. This legislation is intended to encourage and facilitate wider participation by private institutions in the markets for mortgage-backed securities, primarily by amending federal securities laws and by preempting certain state securities and investment statutes.

You have indicated that your Subcommittee is concerned primarily about the implications of such measures for investor protection. You also have raised questions about the impact of the proposed legislation on the sectoral allocation of capital and on the performance of the economy as a whole. After briefly reviewing the status of the markets for private mortgage-backed securities, I will turn to the issues of investor protection and economic impact raised by the legislation under consideration. Let me say at the outset, however, that your emphasis on investor protection is well placed. It is a vital public policy concern that the emerging market for private mortage-backed securities be subject to adequate degrees of federal supervision and regulation. Abuses early in the game not only could compromise the interests of individual investors but also could seriously undermine the process of development of this market.

Mortgage securities markets, of course, have been an important component of the housing finance system during the past decade. Furthermore, the need for such markets is likely to increase in the future, particularly if thrift institutions utilize the expanded asset powers recently provided to them by law and regulation. To better match the duration and interest rate sensitivity of assets with liabilities, thrifts and other mortgage originators with predominantly short-term debts may move more and more long-term mortgages to investors through the secondary markets. Mortgage pass-through securities, which represent ownership interests in pools of residential loans, can be the most efficient secondary market instruments to accomplish this type of shift.

Since the early 1970s, the thrust of public policy has been to encourage development and growth of markets for mortgage pass-through securities guaranteed by federal agencies and federally sponsored enterprises. By the end of last year, outstanding pass-through securities guaranteed by the Government National Mortgage Association (GNMA), the Federal Home Loan Mortgage Corporation (FHLMC), or the Federal National Mortgage Association (FNMA) totaled $243 billion--equivalent to nearly a fifth of all residential mortgage debt outstanding.

By contrast, development of markets for fully private mortgage pass-through securities--that is, securities without federal sponsorship issued against pools of conventional loans--has been quite modest. While a fair number of banks, thrift institutions, mortgage companies, insurance companies and so-called conduit organizations have issued private pass-throughs, available estimates suggest that the total amount outstanding is only about $10 billion. To date, private institutions have been successful mainly in the market space left by FNMA and FHLMC. Most issues have been private placements tailored to the needs or preferences of individual investors or public offerings issued against pools of those mortgage loans that are individually larger in amount than those which may be purchased by the federally sponsored enterprises under limits established by Congress.

Private pass-through securities generally have been unable to compete, head to head, against those issued and/or guaranteed by federal agencies and federally sponsored enterprises, largely because of the market benefits enjoyed by these federally related entities. But development of the private market also has been hampered by state and federal laws and regulations that have increased the cost of issuing private securities or have constrained investment in private pass-throughs by various types of institutions. The President's Commission on Housing, on which I served as a member before being appointed to the Federal Reserve Board, identified a host of legal and regulatory impediments in its 1982 report.

The Federal Reserve Board traditionally supports measures that promise to improve the efficiency of private financial markets. In this case, we believe that changes in laws and regulations that encourage a broadening of the mortgage pass-through securities markets through more extensive involvement of the private sector would constitute sound public policy, so long as other legitimate public policy objectives are not compromised in the process. It certainly seems appropriate to adjust laws and regulations that have disadvantaged the competitive position of private mortgage securities in our financial markets with inadvertent or unintended constraints and obstacles. Indeed, some technical problems have been caused by state or federal statutes or regulations written long before mortgage-backed securities were a significant market factor, and some impediments have arisen because of inadequate understanding of the unique nature of these securities.

Some of these types of technical constraints recently have been alleviated by regulatory changes at the federal level. For example, last year the Securities and Exchange Commission tailored some of its registration and disclosure requirements to the special characteristics of private mortgage pass-through securities, recognizing the need for both shelf registration procedures and sales of these securities on a "blind pool" basis. At the Federal Reserve Board, we have amended Regulation T--which governs margin credit extended by brokers and dealers for the purpose of purchasing or carrying securities--to specify that private mortgage-backed securities are eligible collateral for such credit. We also have tailored the Regulation T criterion to fit special features of the mortgage instruments--that is, the amortizing or depreciating nature of mortgage securities.

Some components of Title I of H.R. 4557 also constitute technical amendments designed to accommodate properly private mortgage securities. Sec. 108, which would require the Securities and Exchange Commission to provide a permanent procedure for the delayed or continuous registration of private mortgage-backed securities, falls into this category. These types of registration procedures, which are vital to the success of a public market in mortgage securities, currently are available under an administrative rule of the Commission. A legislative mandate to the SEC would remove any market uncertainty over the future of these flexible registration procedures.

The removal of statutory limitations on investment in mortgage pass-through securities by federally chartered financial institutions, leaving it up to the regulators to specify investment limits as well as factors relating to the diversity of underlying mortgage pools, is another appropriate technical adjustment (Sec. 106). The current law for national banks, for example, limits investment in the securities of any one issuer to a percentage of unimpaired capital stock and surplus and, in effect, treats private mortgage pass-through securities as obligations of the issuer rather than as shares in pools of loans constituting the obligations of many mortgage borrowers. The current treatment for banks is a good example of law that does not properly accommodate the true nature of mortgage pass-through securities.

I understand that this Subcommittee is concerned that some of the provisions of Title I of H.R. 4557 may go beyond technical adjustments to law and regulation. Any provisions that involve tradeoffs of policy objectives, of course, need to be considered carefully. As a general principle, caution should be exercised whenever federal or state laws that were intended to protect savers, investors or financial institutions are amended, or preempted, in order to further the development of a particular market. Several provisions of the proposed legislation raise issues along these lines: the exemption of public offerings of private mortgage-backed securities from federal registration and disclosure requirements; the federal preemption of state legal-investment and blue-sky laws applicable to private mortgage-backed securities; and the provisions that seek to facilitate development of forward-delivery markets for such securities by amending federal laws relating to the extension of margin credit by securities brokers or dealers.

The proposed exemption from securities registration requirements (Sec. 101)--applicable only to large sales (those over $250,000) of "investment grade" mortgage-backed securities (those rated in one of the top four categories by a nationally recognized statistical rating organization) by financial institutions to investors for their own accounts--generally appears to be a desirable extension of the current transactional exemption for mortgages and mortgage participations contained in federal securities law. Such large transactions presumably involve investors with a high level of sophistication and thus do not require all of the normal investor protections provided by the 1933 Act.

The Congress, however, should recognize the implications of several aspects of the proposed exemption. First, reliance would be placed upon private rating organizations to set market standards. There is no assurance that these organizations will retain their current rating schemes or will not adjust their rating categories in a manner inconsistent with the risk levels anticipated by Congress. Second, the exemption would be extended to all HUD-approved mortgagees, including mortgage companies that are not subject to the same levels of supervision, regulation and examination applicable to depository institutions. These factors raise questions about two important aspects of consumer protection in the private market for pass-through securities: adequate information about the quality of mortgages in the underlying pools, and adequate assurance of performance by the issuer/servicer over the life of the pass-through security. It may be appropriate to design a simplified, special-purpose set of SEC registration requirements for the types of transactions envisioned in Sec. 101, specifying pertinent characteristics of the pooled mortgages as well as the responsibilities of the issuer/servicer.

Federal preemption of state blue-sky and legal-investment laws for investment grade mortgage-backed securities (Sec. 107) raises further questions about investor protection as well as about the interests of savers in state-chartered depository institutions, life insurance companies and pension funds. "Investment grade" is not a particularly strict standard and, in fact, most public offerings of private mortgage pass-through securities have been rated in the top two categories. It may be questionable public policy to require the states to treat all mortgage-backed securities rated in the top four categories by any nationally recognized rating organization as if they were Treasury or federal agency securities, even though the proposed legislation would give the states three years to opt out of the federal preemption. Some states eventually may feel that it is appropriate to apply more stringent legal investment standards than federal law would permit or to require more complete disclosure with respect to the character of the underlying mortgage pools. Thus, it may be preferable to allow the states an unlimited amount of time to override federal preemption of their blue-sky and legal-investment statutes rather than to incorporate private rating service standards in federal law and to set a time limit on the state override.

The provisions that would facilitate development of forward-delivery markets in private mortgage-backed securities, by specifying that contracts made by brokers and dealers for delayed delivery of such securities (within 180 days) do not involve extensions of credit subject to margin limitations (Sec. 103-105), appear to constitute sound public policy. Forward delivery arrangements currently are an integral part of the markets for federally related mortgage pass-through securities, and such arrangements clearly are essential to the success of private markets. Furthermore, under these provisions both the Federal Reserve Board and the Securities and Exchange Commission would have the authority to institute remedial measures if the need should arise, by shortening the forward-delivery period. The SEC also would retain its regulatory authority over self-regulatory broker-dealer organizations to ensure that these organizations maintain adequate margin deposit rules for forward contracts in private mortgage-backed securities. And, of course, the SEC would retain authority to establish minimum net capital requirements that reflect a broker-dealer's exposure in the forward trading market. These types of controls should prevent repetition of some of the problems that arose in the unregulated forward market for GNMA-guaranteed securities several years ago.

The potential impact of the package of measures contained in Title I on the allocation of capital between the housing sector and other sectors of the economy, and on the growth of the economy as a whole, is difficult to judge in quantitative terms. It seems safe to say, however, that changes in law that reduce the costs of issuing private mortgage pass-through securities or enhance the attractiveness of these securities to investors should translate into lower costs of mortgage credit for the ultimate borrowers whose loans are in the pools behind the securities. Thus, enactment of Title I should encourage more capital to flow into the housing sector and less to flow to other private sectors. If this process altered capital allocation away from plant and equipment, there could be some impact on business productivity growth over time.

These types of conclusions assume, of course, that the provisions in the proposed legislation are the only adjustments that are made to the structure of the secondary mortgage markets. If the measures designed to enhance the development of the private secondary markets were coupled with measures designed to limit the secondary market activities of the federally sponsored enterprises, any potential impacts of the legislation currently under consideration on capital allocation and economic growth could be altered.

A shift of secondary market functions from the public to the private sector may now be a proper course for public policy, following more than a decade of valuable demonstration and market development by the federally related entities. Both FNMA and FHLMC have done pathbreaking work by helping to standardize the conventional home mortgage instrument and by moving large amounts of pass-through securities issued against pools of such loans into a capital market that had been unaccustomed to conventional pass-throughs. We have now reached a point where conventional mortgage documents are standardized nationally, where mortgage pass-through securities are a familiar instrument in national financial markets, and where the private mortgage insurance industry is capable of providing mortgage pool insurance necessary to secure high ratings for a large volume of conventional pass-throughs. These foundations, coupled with the types of legal adjustments contained in Title I of H.R. 4557--and perhaps with the creation of more flexible mortgage investment trusts under federal tax law--can provide the basis for a viable private secondary mortgage market that can serve the needs of the housing industry during the years ahead.

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