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STATEMENT ON THE GROWING SECONDARY MORTGAGE MARKET AND IMPLICATIONS FOR PARTICIPATING BANKS AND THEIR REGULATION

PRESENTED TO

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
SUBCOMMITTEE ON GENERAL OVERSIGHT AND INVESTIGATIONS

BY

A. DAVID MEADOWS
ASSOCIATE DIRECTOR, DIVISION OF BANK SUPERVISION
FEDERAL DEPOSIT INSURANCE CORPORATION

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Mr. Chairman, and members of the subcommittee, I welcome the opportunity to discuss with you the FDIC's perception of the growing secondary mortgage market and our supervisory practices as they relate to mortgage packaging activities.

The growth of the secondary mortgage market and increased involvement by commercial banks and thrifts is placing greater responsibility on bankers and regulators. The secondary mortgage market originally developed because of an imbalance in the supply and demand of mortgage funds. Borrowers (home purchasers) were demanding more money than the traditional mortgage lenders (financial institutions that would retain the mortgages in portfolio) were able or willing to provide. This "mortgage credit gap", estimated at $150 billion in 1984 is expected to grow to $350 billion in 1990. The market fills the gap by making mortgages attractive and available to non-traditional investors. The pooling of mortgages and insurance on the pools can make investment decisions simpler, provide liquidity and protect against credit loss. Unfortunately, the mortgage insurers have been plagued since 1981 by mounting foreclosures and losses. There are three basic reasons why these insurance company losses are occurring. First, significantly lower inflation accompanied by little real estate appreciation in the 1980's means that ever increasing home prices will not eventually bailout high risk loans. Secondly, the insurers priced their products far too low considering the risk they were incurring.

Thirdly, underwriting standards were overly-liberalized. Borrowers were qualified on the basis of initial teaser loan rates, not at the much higher rates they would pay after the subsidized period (usually no longer than five years). Also minimal down payments (5% was common) meant that borrowers with a nominal investment had little incentive not to abandon properties in time of economic hardship or depressed real estate prices.

A positive influence on the banking system is exerted by the secondary mortgage market despite the recently disclosed problems involving Bank of America and the increasing rate of past due mortgage loans and foreclosures. The secondary market provides liquidity and broadens the number of potential investors. This tends to increase competition for mortgages and thus lower interest rates, certainly a positive influence on the construction industry.

The problems in the secondary market appear to be the fault of the people dealing in the market, not the market, per se. Insurers have been at fault for relaxing underwriting standards and even insuring loans not conforming to these standards. Our examiners have noted instances of insurers issuing binders on mortgage pools containing a significant number of loans not conforming on the basis of borrower repayment ability or loan terms. There has been evidence that the insurers have not been validating the loans they have been insuring. Fortunately, there are indications that this is beginning to change. The insurers are repricing the insurance and tightening underwriting standards. For example, it was previously common to charge the builder four or five points for granting financing. With appraised value at purchase price this translates into actually no borrower equity if one presumes that the points should be deducted from the price to get at true market value. Many insurers will now permit the charge of only one point.

Mutual savings banks seem to be the primary participants in the secondary market among FDIC supervised institutions with little activity noted in commercial banks under our supervision. Savings banks, as with other thrifts, are able to attract deposits but have not generated a large loan demand within their trade areas. They are also aggressively seeking out sources of income to improve their earnings positions. A purchaser in the secondary mortgage market may gain an attractive long-term investment with interest rate protection if the mortgages are adjustable rate, but many are fixed rate and present interest rate risk. In addition to interest income received, the purchaser also receives from the originators a portion of the points charged on the mortgages. A seller in the market may enhance earnings through reinvestment of funds, collection of fees and, as often occurs, retaining of mortgage servicing rights. There are liquidity considerations for a seller, depending on the strength of the secondary market. Although there is some activity as seller, most of the institutions under our supervision are purchasers.

The purchasing institutions have been placing undue reliance on a reputable middleman such as Bank of America and the insurer for protection. They have not required that the purchased loans conform to either their own or the insurer's underwriting criteria. This is in the process of change, not only because of more attention by the regulators, but also because of media attention to the insurer's problems. Banks <u>must</u> look to the quality of the underlying loans for repayment; insurance should only be thought of as a secondary level of support. However, even as secondary support it is prudent to analyze the financial capacity of the insurer to ascertain whether or not the insurer does in fact provide a meaningful level of comfort.

The responsibility for prudent conduct of bank activities in the secondary mortgage market, as in any financial market, rests with bank management. In fulfilling this responsibility, bank management is obligated to establish and maintain appropriate policies and procedures. Also, to ensure compliance with and gauge effectiveness of the policies and procedures, an adequate system of internal controls must be developed and enforced. Management's fulfillment of its responsibility assumes even greater importance when a bank engages in activities or markets either new to the bank or of recent development, such as mortgage purchasing in the secondary market. Unidentified risks are present in these situtations and concern the areas of administration and accounting, credit quality and possibility of misrepresentation or fraud.

The bank examination process is the FDIC's primary supervisory tool in discovering the existence of unhealthy or deterioriating conditions through the examiner's evaluation of a bank's capital adequacy, asset quality, management, earnings capacity and liquidity position. The examination is designed to provide a factual foundation to base corrective measures and recommendations. Thus, it can help prevent problem situations from remaining uncorrected and deteriorating to the point where costly financial assistance by the FDIC, or even a payoff becomes unavoidable. Although we do not have specifically designated procedures to cover mortgage purchasing, our examination process is believed adequate in addressing bank risk in such activities.

The overall appraisal of management is an important element of the examination. Our examiners evaluate bank management with respect to virtually all factors considered necessary to operate a bank within acceptabe banking practices and in a safe and sound manner. These factors include, but are not limited to technical competence, leadership and administrative ability, compliance with regulations and statutes, ability to plan and respond to different and changing circumstances, adequacy of compliance with internal policies, procedures and controls and tendencies toward self dealing. Needless to say, a bank's management is the key influence over a bank's performance and condition as assessed in the examination.

Examinations are not undertaken for the detection of fraud nor to assure the absolute correctness and appropriateness of records. The overall assessment of a bank's system of internal control is, however, an important examination function. In most cases, such an appraisal is accomplished by an overall evaluation of the internal control system, a specific review of audit systems and reports, and performance of standard examination procedures. In some instances, all or a portion of a bank's system of internal control may be deficient, or management or the condition of a particular institution may be such that more intensive audit tests, suited to the particular circumstances are undertaken. While examinations are not conducted for the purpose of uncovering fraud, our examiners are alert to its possible existence.

It is the FDIC's policy to encourage every bank to adopt and maintain an adequate audit program. Such a program is the responsibility of prudent bank management and essential to an effective internal control system. Ideally, a program would consist of a full-time continuous program of internal audit and an annual outside audit. Our examiners place a priority on analyzing a bank's audit system and reports.

The FDIC's examination process lessens in no way bank management's responsibilities for proper conduct of bank activities in the secondary mortgage market or any other market in which the bank is allowed to do business in, whether as an agent or principal. In fact we continually reenforce that responsibility and its importance at examinations, by corrective programs and at open forums such as this one. There are risks for participants in the secondary mortgage market. Bank management must be aware of them, weigh the pluses and minuses to the individual bank of participating, and assure that sufficient policies, procedures and controls exist, or can be put in place.