For release on delivery
Expected at 9:30 A.M. EDT
September 22, 1983

Statement by

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before the

Subcommittee on Housing and Urban Affairs

United States Senate

September 22, 1983

Mr. Chairman and Members of the Committee, I appreciate the opportunity to present my personal views on the general thrust of Senate 1821 and 1822, bills that are designed to widen and deepen the secondary mortgage market of this nation. The Committee knows the importance of enhancing the growth of this already enormous source of funding for housing. Fundamental involvement in housing finance has been, on balance, a successful public policy spanning five decades or more. I believe an important aspect of that success has been heavy reliance on private institutions and market processes. Permit me to admit my pride in my own involvement in the Federal Home Loan Bank System's expansion of its credit facilities in the 1970s as well as the part I played in the founding and initial operating policies of the Federal Home Loan Mortgage Corporation, with Chairman Thomas Bomar.

The very success of public policy in the utilization of market processes to further homeownership and residential financing provides the platform from which private market initiatives can and should now be launched. Thirteen years ago my associates and I came before this Committee to advocate the establishment of a secondary market facility for conventional mortgage loans. Our plea then to Chairman Sparkman, Senator Proxmire and others was to obtain authority to demonstrate the feasibility of the conventional mortgage backed security, but we predicted at that time that the private market eventually could and would take over the function. I believe the time has now arrived for that transfer to be stimulated, while at the same time recognizing the outstanding accomplishments of both Fannie Mae and Freddie Mac, and their present strong leadership. The ability of both of these organizations to finance at rates not far from comparable maturity Treasury securities exemplifies the size, presence and position they have attained in the capital markets. I am confident that both organizations would continue to compete effectively with stronger private rivals.

The conventional mortgage backed security has proven its worth in the credit markets, even during the most recent recession that saw severely depressed housing conditions and falling house prices in some submarkets. Mortgage pools of high quality have been found repeatedly and recently to be safe investments, and the securities have involved credit risk insurance and other arrangements to protect investors and maintain cash flow. It seems to me that the record supports the objectives and thrust of the legislation which is the subject of this hearing.

The growth of secondary mortgage market activity, of course, has been very substantial since the late 1960s. Furthermore, the need for secondary market channels is likely to increase in the future, to the extent that some 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, some thrifts and other mortgage originators may move more and more mortgages to investors through the secondary markets. Of course, another constructive option open to them in this regard would be to promote and invest in more variable-rate mortgage instruments.

Pass-through securities are relatively new and effective secondary market vehicles that attract a wide variety of capital market investors into mortgage instruments. Since the early 1970s, the thrust of public policy has been to encourage development and growth of markets for securities guaranteed by federal agencies and federally sponsored enterprises. By the middle of this year, pass-throughs guaranteed by the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Federal National Mortgage Association totaled \$211 billion--equivalent to a sixth of all residential mortgage debt outstanding. GNMA securities, issued exclusively against pools of federally insured or guaranteed mortgages, account for two-thirds of all federally guaranteed pass-throughs outstanding. But the volume of FHLMC and FNMA securities, issued primarily against pools of conventional loans, has been expanding very rapidly since late 1981. The managements of those entities have helped to fill a mortgage credit gap during a critical financial adjustment period.

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 less than $10 billion.

In my judgment, it would be sound public policy to change laws and regulations, where appropriate, to encourage a broadening of the secondary mortgage market through more extensive involvement of the private sector. 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 to development of the private mortgage securities markets in its 1982 report. As you noted when introducing S.1821 and S.1822, components of these legislative proposals attempt to crystalize Housing Commission recommendations for encouragement of private securities as well as to formalize the "TIMs" proposal that grew out of the Commission's work.

As you also noted when introducing this legislation, a comprehensive look at both private and public secondary market institutions is in order. It is obvious that federal policy toward the two sponsored enterprises, FNMA and FHLMC, will help determine the competitive position of private mortgage-related securities in the conventional mortgage market and in the nation's capital markets. As a general principle, I am fully in favor of improving the efficiency of private financial markets and reducing reliance on the government's presence in the credit system, as long as these objectives can be achieved without seriously compromising other legitimate social and economic goals. As these hearing have amply demonstrated, difficult questions concerning the proper balance of public policy and tradeoffs of competing objectives inevitably arise in this context.

I will concentrate the balance of my remarks on two topics. First, the types of legal and regulatory adjustments appropriate to bolster development of the private securities markets--the major focus of the legislation you have introduced. Second, possible government policy toward the federally sponsored secondary mortgage market enterprises. In the latter area, my comments necessarily will be broad and suggestive since no specific legislative proposals are extant.

<u>Private Mortgage-related Securities</u>

Laws and regulations that have unfairly disadvantaged the competitive position of private mortgage securities in our financial markets do not constitute good public policy, and should be modified. In this regard, I'm talking about inadvertent, or unintended, constraints and obstacles for the issuer of private securities. At the Housing Commission, we determined that there have been a number of such constraints, sometimes caused by state or federal laws or regulations written long before mortgage-related securities were a significant market factor, or arising because of inadequate understanding by lawmakers or regulators of the nature of mortgage securities.

Some of these constraints recently have been alleviated by regulatory changes at the federal level, in line with Housing Commission recommendations. For example, the SEC has tailored some of its registration requirements to the special characteristics of both the private mortgage pass-through securities and the issuers of these types of securities. 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 concerning marketability of securities in margin accounts to fit special features of the mortgage instruments.

Some components of Title I of S.1821 also constitute technical amendments designed to accommodate properly private mortgage securities. I am referring to such things as the removal of statutory limitations on investment in mortgage-related 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. The law for national banks, in effect, currently treats mortgage pass-through securities as obligations of the issuer or sponsor rather than as shares in pools of loans constituting the obligations of mortgage borrowers. The current treatment is a good example of law that does not recognize the true nature of mortgage pass-through securities.

Some components of Title I of S.1821 obviously go beyond the types of technical adjustment to law and regulation I have been discussing and may involve some tradeoffs of policy objectives that need to be considered carefully. Caution should be exercised whenever federal or state laws or regulations, designed to protect savers, investors or financial institutions, are amended, or preempted, in order to accommodate the development of a particular market.

It appears that investor protection conceivably could be compromised, for example, if the SEC registration exemption currently available to financial institutions supervised and examined by state or federal regulators were extended to any HUD-approved mortgagee. The integrity of today's mortgage banking industry is not in question. But mortgage bankers basically are unregulated institutions, and consideration should be given to ways to set and monitor quality standards for mortgages "pooled." I would hate to see isolated problems in the future undermine development of the private mortgage securities market.

The provision of S.1821 that would involve federal preemption of state blue-sky and legal-investment laws and regulations for all investment grade mortgage-related securities, subject to reversal by the states within two years, raises further questions about investor protection as well as the interests of savers in state-chartered depository institutions, life insurance companies and pension funds. As I understand the term, "investment grade" is not a particularly strict standard, and commonly is interpreted to cover the top four categories used by the nationally recognized rating firms--extending down to BBB under Standard and Poor's designations. Most public offerings of private mortgage pass-through securities, in fact, have been rated in the top two categories, and it may be questionable public policy to require the states to treat all investment grade issues as if they were Treasury or agency securities.

On a subject closer to the Federal Reserve, I would like to raise some questions about the provision that would grant authority for national banks to underwrite and deal in private mortgage-related securities. The Federal Reserve has been concerned that underwriting private securities, particularly corporate bonds, could involve unusual elements of risk for banks and possibly could lead to conflicts of interest in the provision of credit.

Though equivalent risks presumably would not arise in the pass-through securities markets--banks already have the authority to underwrite issues guaranteed by GNMA, FNMA and FHLMC--it is an area that should receive some consideration in this legislative process.

Concerning S.1822, a bill that would establish a new type of mortgage investment trust under the tax code, I can enthusiastically support the effort to create more flexible trust devices that would retain the flow-through federal income tax features critical to pass-through securities markets. The Housing Commission had discussed the need for new types of trust devices for issuers of mortgage-related securities, as alternatives to the so-called "grantor trust" currently used for virtually all pass-through issues. As I see it, the major objectives of the effort to establish new trust devices should be to permit issuance of different classes of securities against a mortgage pool and to allow some degree of management of assets and cash flows by the trustee. Such features could be used to tailor issues to the maturity and cash-flow preferences of different types of investors and could result in more advantageous pricing of pool securities--thus leading to lower mortgage rates for consumers. Thrift institution issuers, for example, would have the opportunity to market the longer term classes and retain the shorter term securities, aiding their adjustment of liabilities and assets into a better maturity balance.

I am not prepared at this time to testify on the many technical aspects in S.1822. One thing missing in that bill, however, is reference either to quality standards for the "TIM" securities or to supervision of the trustees or managers of TIMs. At the Housing Commission, we considered the need for minimum quality criteria for new types of mortgage trust vehicles, in order to promote standardization in the private securities market and to obtain favorable treatment of securities by the Department of Labor (for private pension funds) and possibly by state regulators (for fiduciaries under their jurisdiction). I am concerned that creation of new types of mortgage investment trusts, that apparently could take a variety of forms (corporate or otherwise) under S.1822, and that would permit trustees to actively manage the funds entrusted to them by individual investors, would create leeway for bad reinvestment decisions or even for abusive practices by trustees or managers. Such events, of course, could heavily damage all elements of the private mortgage pass-through securities market.

It's difficult to specify, at this time, the type of supervisory structure within which TIMs ideally should operate. One possibility would be to require that TIMs be subject to the types of controls established for mutual funds registered under the Investment Company Act of 1940--other entities with flow-through tax treatment under the Internal Revenue Code. Another possibility would be to involve federal agencies with considerable expertise in housing finance, such as the Federal Home Loan Bank Board, in the supervisory process.

Federally Sponsored Credit Agencies

The federally sponsored secondary market enterprises certainly have performed important functions quite well, introducing new types of secondary market instruments and developing channels between conventional mortgage borrowers and a wide range of capital market investors. A little over a decade ago, such channels were virtually nonexistent and, as you know, I was directly involved in the establishment of FHLMC as a secondary market facility for conventional mortgages. 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 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. Should we, therefore, conclude that the federally sponsored secondary market agencies have completed their job? Is it time to remove whatever legal and regulatory elements have been impeding development of the private market--the intent of S.1821 and S.1822--and at the same time sever the federal connections of FNMA and FHLMC?

As a general principle, it seems obvious to me that the use of federal enterprise status, and the special advantages that go with this status, should be reserved for those activities that are not, or cannot be, performed adequately by the private sector. It may be possible for the private sector to develop a large and efficient market for mortgage-related securities that would provide mortgage borrowers ready access to funds in the broad capital market structure at competitive prices--your legislative proposals are aimed in this direction. But as a former issuer of private mortgage-backed securities, it is not clear to me that fully private securities will be able to compete successfully, head to head, with federally guaranteed instruments, even if the legislative package you have introduced should become law. To date, private securities have been successful mainly in the market space left by FNMA and FHLMC. Most issues have been private placements tailored to individual investors or public offerings issued against pools of loans larger than those that can be purchased by the federally sponsored enterprises.

Although it is possible to argue for a phase-down of the federal connections of FNMA and FHLMC--in concert with development of viable private sector alternatives--it should also be recognized that the federally sponsored enterprises can provide some public benefits that cannot be provided by private alternatives. In particular, these enterprises are in a position to funnel the benefits of their federal connections to mortgage borrowers. Thus, one policy option is to ensure that the benefits accrue to borrowers most in need of aid, as identified through the political process. This approach would seek to target the mortgage securities programs of FNMA and FHLMC, in terms of criteria such as maximum loan size or borrower income.

If Congress decides that privatization of one or both of the sponsored enterprises is the appropriate policy objective over the long term, some transition problems will have to be faced. For one thing, the rights of holders of outstanding stock, debt, and guaranteed pass-through securities would have to be protected. And, of course, it would be unwise to sever federal connections unless the sponsored enterprises could function effectively on their own. The Federal Home Loan Mortgage Corporation currently is in a healthy financial condition. But more difficult transition issues would be raised with the Federal National Mortgage Association because of its large portfolio of mortgages having interest rates below current market levels.

As a final point, I would like to remind the subcommittee that housing finance is likely to be the first casualty in any future "crowding out" of private financing occasioned by the huge structural federal deficits that are on the horizon. It would be unfortunate, indeed, if this problem were compounded by inefficient market mechanisms. As pointed out in the Report of the President's Commission on Housing (p. 116), "Since the mid-1960s, the ability of the housing finance system to meet the needs of borrowers has deteriorated markedly on several occasions, and this system currently is in a serious state of disrepair. The volume of residential mortgage lending naturally reflects changes in financial market conditions because the sensitivity of demand for mortgage credit to changes in interest rates is high relative to interest rate sensitivity in other major sectors of the economy. However, the increasingly wide swings in residential mortgage and housing construction activity also are traceable to structural shortcomings in the housing finance system."

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