

Chapter 1

An Overview of Mortgage Lending

In This Chapter

Mortgage lending is a profession that requires knowledge of many disciplines, including real estate, finance, appraisal, and others to be effective. This chapter provides an overview of the mortgage lending industry, beginning with a brief history of mortgage lending in the United States. Federal legislation transformed a period of uncertainty into the thriving mortgage industry we have today. The role of the primary mortgage market and how it is sustained and renewed by the secondary mortgage market is reviewed.

At the end of this chapter, you will be able to:

- Identify historical events affecting today's mortgage industry.
- Contrast the primary mortgage market and secondary mortgage market.
- Identify entities involved in the primary mortgage market and the secondary market.
- Identify the regulatory agencies involved in mortgage lending.
- Discuss the seeds of the subprime mortgage crisis.

Demand Deposits

Disintermediation

Federal Home Loan Mortgage Corporation (Freddie Mac)

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Government National Mortgage Association (Ginnie Mae)

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Mortgage

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A Brief History of Mortgage Lending

Real estate cycles are part of the mortgage industry. However, in the past few years we have experienced an unprecedented economic and real estate crisis, and the outcome is still uncertain. Economists and industry experts continue to analyze, asking: What caused this crisis? Whose fault was it? What could we have done differently to avoid this? What can we do to make sure this never happens again? All of these questions will be answered in time. For now, we can provide some background on these issues, with the understanding that almost every aspect of the mortgage industry has influenced the current state of affairs:

- Political leaders and housing advocates felt it was everyone's right to own a home, even when perhaps not everyone was ready for the commitment of homeownership.
- Wall Street and investors paid higher priced incentives for subprime loans.
- Government-sponsored enterprises (GSEs) relaxed underwriting standards for conventional mortgage guidelines through automation.
- Unethical appraisers inflated values under pressure from clients.
- Unethical mortgage loan originators placed borrowers in loan programs based upon personal profit and not suitability.
- Consumers purchased homes they could not realistically afford.
- Mortgage products allowed financing with no loan documentation.

The Seeds of Today's Mortgage Industry

In the United States from the 1900s through the 1930s, buying a home was a much different process than it is today. When banks first started making home mortgage loans, a purchaser would typically have to make a large down payment (as much as 50% of the purchase price) and accept a loan that had a balloon payment due after a very short term (as short as a year or two, but almost never more than five years). This meant that borrowers were forced into a constant cycle of refinancing, with no interest rate security.

Several events led to the mortgage industry we have today. First, the Federal Reserve Act of 1913 created the **Federal Reserve System**. This Act established a federal charter for banks that permitted them to make real estate loans. Although these loans were initially the short-term, high down payment loans just referenced, the Act established the framework for government involvement with mortgage lending. Furthermore, the Federal Reserve Act was instrumental in implementing a system for the government to influence interest rates. Other significant banking legislation followed:

- The **Federal Home Loan Bank Act of 1932**, passed during the height of the Great Depression, established **Federal Home Loan Banks**, which had the authority to lend money to thrifts—savings and loan associations (S & Ls), credit unions, and savings banks—so that they could finance home mortgages in their neighborhoods.
- The **Banking Act of 1933**, also known as the Glass-Steagall Act, created the **Federal Deposit Insurance Corporation (FDIC)** to insure depositors against bank default. This was an important step in enticing people to, once again, save their money in banks. This allowed the banks to have a continued source of funds to make more home mortgage loans.
- The **National Housing Act of 1934** extended this protection to savings and loan depositors with the creation of the **Federal Savings and Loan Insurance Corporation (FSLIC)**. After the savings and loans crisis of the 1980s exhausted FSLIC reserves, it was abolished by the federal **Financial Institutions Reform Recovery and Enforcement Act (FIRREA)** in 1989. FIRREA transferred all assets previously held by FSLIC to the Savings Association Insurance Fund (SAIF), a division of the FDIC.

Federal Home Loan Banks

Federal Home Loan Banks (FHL Banks), established in 1932 by the Federal Home Loan Banking Act, are 12 regional cooperative banks that U.S. lending institutions use to finance housing and economic development in their communities. FHL Banks have been the largest source of funding for community lending for eight decades. The purpose of the 12 FHL Banks is to use their collective resources to expand credit opportunities throughout all markets. More than 8,000 lenders are members of the FHL Bank System, representing

approximately 80% of the insured lending institutions in the country. Community banks, thrifts, commercial banks, credit unions, community development financial institutions, insurance companies, and state housing finance agencies are all eligible for membership through the purchase of stock. As the FHL Banks are entirely privately owned by these member-owners, they do not have the pressure for high rates of return required by publicly traded companies. As cooperatives, the FHL Banks pass their government-sponsored enterprise (GSE) benefits to their members in the form of lower borrowing costs, which are passed on to consumers.

Today, FHL Banks contribute 10% of their net income to the **Affordable Housing Program** (AHP). This grant program is the largest source of private sector grants for housing and community development in the country. They also play a part in the funds available for “jumbo loans,” which are those not meeting conforming loan limit guidelines set by secondary market leaders Fannie Mae and Freddie Mac.

Federal Housing Administration (FHA)

The **Federal Housing Administration** (FHA) was created by the National Housing Act of 1934 with the intent of helping the housing industry recover from the Great Depression. The FHA was not intended to fund loans; instead, the FHA provided **mortgage insurance** so banks would not have to incur losses for defaults on home loans. The creation of the FHA allowed banks to commit more of their funds to home mortgage loans, while at the same time improving the quality of those loans by requiring them to conform to FHA standards. Banks that followed FHA guidelines would be reimbursed for the insured amount of any borrower’s default.

Under the FHA program, there are no income limits on borrowers who can take advantage of the program, although the government does limit the mortgage amount that can be insured, based on a sound appraisal and the median price of homes in a particular area.

Because banks are not at risk for borrower default, the FHA was able to create innovative programs and terms over the years for the mortgages they insure. For example, when mortgages required as much as 50% down, the FHA introduced loans that required only a 20% down payment. When short maturities were the norm, the FHA created loan programs with 20-year maturities. This eventually grew to 30 years as the market changed (with 40-year loans not uncommon in some high-cost areas). Finally, the FHA innovated amortizing loans, where the monthly payments would retire the debt over the life of the loan instead of leaving the borrower with a large balloon payment due at the end.

In 1965, the Federal Housing Administration became part of the Department of Housing and Urban Development (HUD). Today, the FHA is the largest insurer of mortgages in the world, insuring over 34 million properties since its inception.

GOVERNMENT-SPONSORED ENTERPRISES (GSEs)

GSEs are entities established by Congress to improve the efficiency of markets and enhance the flow of credit to targeted sectors of the economy. GSEs may serve as financial intermediaries to assist lenders and borrowers, primarily in housing and agriculture, or create a secondary market where loans may be sold. The Federal Home Loan Banks are government-sponsored enterprises, as are secondary market leaders Fannie Mae and Freddie Mac. The federal government has issued recommendations for reform that include the winding down GSEs Fannie Mae and Freddie Mac with a goal of bringing more private capital back into the housing market. Reform of the industry is likely to continue for some time, though the impact of such reforms remains uncertain. Every mortgage loan originator has an obligation to stay current with the changes in the mortgage industry.

Primary Mortgage Market Lenders

Mortgages are *written instruments using real property to secure repayment of a debt*. The process of originating, processing, underwriting, closing, and funding a mortgage occurs in the **primary mortgage market** (or simply, primary markets). This is where borrowers and mortgage loan originators come together to negotiate terms and effectuate mortgage transactions. The primary market is comprised of various lending institutions; for example, commercial banks, savings and loan associations (S & Ls), credit unions, mutual savings banks, mortgage bankers, and mortgage brokers.

Commercial Banks

Commercial banks are *financial institutions that provide a variety of financial services, including loans*. Although banks remain the largest source of investment funds in the country today, until recently, their activities were focused on relatively short-term commercial and consumer loans. Residential mortgages were not a significant part of their business, primarily due to government regulations that limited the amount of long-term investments they could make. These limitations were imposed on commercial banks because the vast majority of the deposits they hold are demand deposits—money that a customer may withdraw from the bank at any time. Demand deposits that are immediately accessible—such as consumer checking accounts—are considered less reliable for reinvesting in long-term real estate loans than other types of bank deposits, such as savings accounts or certificates of deposit (CDs), which customers are expected or required to leave in the bank for longer periods of time.

Recently, commercial banks have increased their participation in home mortgage lending for several reasons:

- Banks want to take advantage of existing customer relationships built through checking accounts and other traditional services.
- Banks anticipate that mortgage borrowers will become bank customers for other services.
- There have been important changes in state and federal banking regulations that require banks to hold different percentages of funds on reserve for different types of loans, based on the perceived risk of those loans. First lien home mortgages with loan-to-value less than 80% are in the lowest risk category. Thus, banks need to maintain fewer funds on reserve to cover losses for home mortgage loans than for other types of loans, leaving more funds available for other loans or investments.

Savings and Loan Associations

Savings and loan associations (S & Ls) —sometimes called **thrifts**—are *financial institutions that specialize in taking savings deposits and making mortgage loans*. Traditionally, S & Ls were the major real estate lending institutions, able to dominate local mortgage markets—even though commercial banks had more assets to invest—mainly because deposits placed with S & Ls were savings deposits less frequently subject to immediate withdrawal than demand deposits (checking) held by banks.

When interest rates surged in the late 1970s and early 1980s, S & Ls, which were limited by law as to how much interest they could pay on savings deposits, were unable to offer attractive returns to depositors. This resulted in widespread **disintermediation**, which is the *loss of deposits to competing investments (e.g., money market funds and government bonds) that offered much higher returns*. Worse, S & Ls were saddled with long-term, non-liquid mortgages at low interest rates (by 1980s standards) that they were unable to sell to the secondary market since, at that time, S & Ls were not using the uniform qualifying standards set by major secondary market investors.

Management mistakes, risky investments, economic slumps—and sometimes fraud—resulted in a dramatic increase in the failure rate of S & Ls, which cost the federal government and taxpayers billions of dollars, leading to a massive restructuring of the industry. Despite this crisis, S & Ls continue to participate as home mortgage lenders, and now follow secondary market qualifying standards. While perhaps a smaller player in the mortgage industry than in the past, S & Ls are required to keep 65% of their assets in mortgage-related activities or it will be required to change its charter.

Mortgage Banking Companies

Mortgage banking companies are institutions that *specialize in making only mortgage loans to consumers*. Unlike banks and other financial institutions, they do not take deposits from customers. They are regulated by federal regulations and the state banking laws applicable to each state in which they do business. There are two types: Mortgage bankers and mortgage brokers.

Mortgage Banker

A **mortgage banker** is a *company, individual, or entity that originates, processes, underwrites, closes/funds, and services mortgage loans*. While mortgage bankers close loans in their own name, they may fund loans with the company's own capital or through a **warehouse line of credit** until it is sold in the secondary market, often immediately.

Even if loans are sold on the secondary market, mortgage bankers may continue to act as agents and service the loans for a fee. Alternatively, they can sell the servicing rights and earn a **service release premium** (SRP), which is the payment received by a lending institution, such as a bank or retail mortgage lender, on the sale of the right to service a closed mortgage loan. to the secondary mortgage market.

Mortgage Brokers

A **mortgage broker** is a *company or individual who, for a fee, places loans with wholesale lenders, but does not service such loans*. Nor do mortgage brokers underwrite or fund their loans, but, rather, act as a conduit in residential mortgages. Among the services that a mortgage broker typically provides are:

- Collecting financial and other required information from borrowers,
- Analyzing income and debt to determine maximum mortgage amounts the borrower can afford,
- Advising borrowers on available loan programs,
- Explaining the loan process,
- Filling out a loan application,
- Providing required disclosures,
- Processing the loan file and submitting it to lenders,
- Assisting borrowers to understand and respond to lender decisions, and
- Participating in the loan closing process.

Brokers often have knowledge of and access to nontraditional lenders who are able to supply a particular type of loan needed to purchase a property, for example, a loan from an investor for a buyer who was turned down by a traditional mortgage lender. However, mortgage brokers do *not* make underwriting decisions.

Other Primary Residential Mortgage Lenders

Among the other types of financial institutions that make originate, process, underwrite, close/fund loans for residential first or second mortgages are credit unions, finance companies, and mutual savings banks.

Credit Unions

Credit unions are *cooperative financial institutions owned and controlled by their members in order to pool their deposits, receive better interest rates, and loan money to fellow members*. Traditionally, credit unions only made home improvement loans and other types of consumer loans. More recently, some credit unions have begun making mortgage loans, both second mortgages, such as home equity loans, and even first mortgages since credit unions can sell secondary market-qualified loans.

Finance Companies

Finance companies are *organizations that specialize in making higher-risk loans at higher interest rates*. Finance companies are sources of second mortgages and home equity loans made directly to borrowers. Although banks and other lenders also make these types of loans, finance companies are often in a position to loan higher percentages of the borrower's equity and work with borrowers who have blemished credit, pricing loans accordingly.

Mutual Savings Banks

Mutual savings banks are *state- or federal-chartered banks that are owned by depositors and operate for their benefit*. They are conservative by nature, and often hold a large portion of their assets in home mortgages. Their activities are usually oriented toward the communities they serve to maintain close supervision of their loans, but modern economic realities have forced mutual savings banks to increase their pool of funds and diversify their mortgage holdings via the secondary market. While they are found mostly in the northeastern United States, there are a number of savings institutions in other areas that continue to operate as mutuals. Like S & Ls, mutual savings banks are known as **thrifts**.

PORTFOLIO LENDING

Portfolio lending is a term to describe the strategy where *financial institutions that make real estate loans keep and service those loans in-house as part of their investment portfolios, instead of selling on the secondary market*. Portfolio lending may be practiced by major financial institutions, smaller community banks, or other types of nontraditional lenders or investors. Portfolio lenders can make lending decisions based on many factors. For example, they may choose to make these types of loans as a service to customers who may need a loan amount larger than can be sold to the secondary market or as an investment because the lender likes the project, rate of return, or possible future profit sharing in a particular real estate venture.

Secondary Mortgage Markets

Originally, banks and other lenders made home mortgage loans to borrowers from deposits they collected directly from other customers. As more people saved more money, the lender could make more loans. But if depositors were not saving money, funds for mortgage loans were not available. This, along with a desire to maximize returns on investment dollars and shift credit risk, led to the creation of the **secondary mortgage markets** (or simply, secondary markets). Secondary markets are *private investors or government agencies that buy and sell real estate mortgages*.

The first secondary mortgage markets were established by the federal government in an attempt to moderate local real estate cycles:

- When the secondary market players buy mortgages from local banks, those local banks then have more money to lend again to other potential homeowners in their area.
- When local banks invest surplus funds in real estate investments from other regions of the country, the effects of local real estate cycles can be moderated as the banks also have stable investments from other areas that may be going through different phases of the real estate cycle.

An important by-product of secondary mortgage markets is the **standardization** of loan criteria. Any changes implemented by secondary mortgage markets become requirements around the country for those wanting to sell mortgages in the secondary market.

Case in Point

Example A: Tenth Bank is in an area that's booming right now. Businesses are coming to the area and lots of people are moving there. Many of these people are looking to purchase a home and have come to Tenth Bank to borrow money. The trouble is, most of Tenth Bank's deposits are already tied up in real estate loans. But, by selling its current home mortgage loans on the secondary market, Tenth Bank can get more money to make new loans. Tenth Bank and its customers are happy, and the effects of a potential credit crunch in the local real estate market are moderated because Tenth Bank can acquire additional funds from national secondary mortgage markets.

Case in Point (continued)

Example B: Later, Tenth Bank finds itself in a different situation. The local community is still doing well, so Tenth Bank has lots of people depositing money in the bank, but there's little activity in the real estate market. With this surplus of deposits, Tenth Bank may have trouble finding enough local investments with a high enough return to purchase. In this case, Tenth Bank could buy real estate mortgage loans on the secondary market. Tenth Bank would also then hold real estate investments from across the country and would not need to worry as much about a down turn in the local real estate market.

Example C: Tenth Bank is considering some new home mortgage loan requests. The loans seem to be riskier for several reasons relating to the borrowers and the property. Tenth Bank is not so quick to approve these loans because, if they don't meet the criteria of the secondary markets, Tenth Bank must hold the loans and cannot sell them to the secondary market. This helps stabilize the local real estate market as it discourages banks from making too many risky loans. Furthermore, the standardized criteria help Tenth Bank feel secure in the mortgage investments it buys on the secondary market from other areas of the country, even though it may never see the actual borrowers and properties it is helping to finance.

Mortgage-Backed Securities

Mortgage-backed securities (MBSs) are *debt obligations that represent claims to the cash flows from pools of mortgage loans*. Mortgage loans purchased from the primary mortgage market are assembled into pools by a government/quasi-governmental entity or a private investor who operates in the secondary mortgage market. Securities are then issued that represent claims on the principal and interest payments made by borrowers on the loans in the pool; a process known as **securitization**. Any asset may be securitized as long as it is cash-flowing. The term mortgage-backed security, therefore, is reflective of the underlying asset in the security.

Common types of mortgage-backed securities include:

- **Pass-through securities**, which are most common, pay interest and principal payments on a monthly basis. Some types pay even if payments aren't collected from the borrower. The investor does not own any particular mortgage, but instead, a proportionate interest in the cash flow generated by the entire pool. The payments of interest, principal, and sometimes prepayment, penalties are passed through to the investor.
- **Stripped mortgage-backed securities** (SMBS) are pass-through securities that are created by separating—or stripping apart—the principal and interest payments from the underlying mortgages that back standard mortgage-backed securities.
- **Collateralized mortgage obligations** (CMOs) are bonds that represent claims to specific cash flows from large pools of home mortgages. The streams of principal and interest payments on the mortgages are distributed to the different classes of CMO interests, known as tranches, according to a complicated deal structure. Each tranche may have different principal balances, coupon rates, prepayment risks, and maturity dates. CMOs may be highly sensitive to changes in interest rates and any resulting change in the rate at which homeowners sell their properties, refinance, or otherwise prepay their loans. Investors in these securities may not only be subjected to this prepayment risk, but also exposed to significant market and liquidity risks.

Secondary Market Participants

Secondary markets are generally defined as private investors and government agencies that buy and sell real estate mortgages, although private investors tend to be a much smaller percentage of the secondary markets. These private investors can be Wall Street or investment brokers, high-risk investors, insurance companies, or pension plans, for example. This discussion will focus on three organizations responsible for the vast majority of the secondary mortgage market activity:

- Federal National Mortgage Association (FNMA or Fannie Mae)

- Government National Mortgage Association (GNMA or Ginnie Mae)
- Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac)

Fannie Mae and Freddie Mac, both government-sponsored enterprises, securitize and keep loans and mortgage-backed securities in their portfolios. They both have substantially similar charters and regulatory structures. Ginnie Mae, on the other hand, is a wholly-owned government corporation, not a GSE. Also, unlike Freddie Mac and Fannie Mae, Ginnie Mae does not purchase mortgages from lenders, nor does it buy, sell, or issue securities.

Federal National Mortgage Association

The **Federal National Mortgage Association** is the nation's largest investor in residential mortgages. Fannie Mae was originally chartered as a GSE by Congress in 1938 to provide liquidity and stability to the U.S. housing and mortgage markets, primarily as a place for lenders to sell their FHA-insured loans. In 1968, Fannie Mae was made a private shareholder-owned company and remains in that structure today, though in 2008, it was placed in conservatorship under the Federal Housing Finance Agency because of severe financial and cash flow problems resulting from the declining real estate market and mortgage foreclosure epidemic.

Fannie Mae buys mortgages (conventional, FHA, or VA) or interests in pools of mortgages from lenders. The lender, who must own a certain amount of stock in Fannie Mae, assembles a pool of loans, and then a participation interest in that pool (usually 50% to 95%) is sold to Fannie Mae. Loans sold to Fannie Mae are usually serviced by the originating lender or another mortgage servicing company (called a subservicer), for which Fannie Mae pays a service fee.

Fannie Mae pools loans that generally conform to its standards and converts them into mortgage-backed securities, which it guarantees as to timely payment of principal and interest. In this way, both the lender and Fannie Mae own an interest in the loans.

Government National Mortgage Association

The **Government National Mortgage Association** was created in 1968 as a government-owned corporation, operating under the Department of Housing and Urban Development (HUD). A primary function of Ginnie Mae is to promote investment by guaranteeing the payment of principal and interest on FHA, VA, Rural Housing Service, or HUD's Office of Public and Indian Housing federally insured or guaranteed mortgages through its mortgage-backed securities program. Ginnie Mae's mortgage-backed securities are the only ones that carry the full faith and credit guarantee of the United States government. Therefore, regardless of whether the mortgage payment is made, investors will receive payments.

Federal Home Loan Mortgage Corporation

The **Federal Home Loan Mortgage Corporation** was created in 1970 as a nonprofit, federally chartered institution controlled by the Federal Home Loan Bank System. Like Fannie Mae, Freddie Mac buys mortgages on the secondary market, pools them, and sells them as a mortgage-backed security to investors on the open market. Also like Fannie Mae, Freddie Mac was converted to a privately held stock corporation and is currently under the conservatorship of the Federal Housing Finance Agency.

Freddie Mac actively sells the mortgage loans from its portfolio to investors throughout the world by issuing its own mortgage-backed securities, thus acting as a conduit for mortgage investments. The funds generated by the sale of the mortgages are then used to purchase more mortgages. While its MBSs are not backed by the full faith and credit of the federal government, Freddie Mac, like Fannie Mae, has special authority to borrow from the U.S. Treasury in order to continue operating in the secondary market.

Secondary Market Standards

An important reason why the secondary market is able to function as it does is that standardized underwriting criteria are used to qualify borrowers and property. Once lenders realized the advantages of selling their home mortgages in the secondary market, they were quick to conform to the underwriting guidelines—such as loan-to-value and income expense ratios—established by Fannie Mae and Freddie Mac, along with other secondary market agencies. Furthermore, both Fannie Mae and Freddie Mac rely on automated underwriting

systems (AUS) that they have developed to further streamline and standardize the underwriting process. Fannie Mae uses Desktop Underwriter® (DU®) and Freddie Mac uses Loan Prospector® (LP®).

Because the secondary market performs such an important function in providing liquidity of mortgage funds, the standards set by the secondary market have a great influence on lending activities in the primary market. For example, once secondary agencies began accepting adjustable rate mortgages (ARMs), 15-year fixed rate mortgages, and convertible ARMs, these types of financing became more readily available in the primary market. Lenders were more willing to make these kinds of loans when they knew the loans could be sold to the secondary market. In contrast, option ARMs and no documentation/no qualification loans are not being purchased by the secondary market today; therefore, these types of financing are virtually nonexistent, although FHA may allow no income, no asset verification refinance loans on existing FHA loans.

While the agencies may relax or tighten their standards in response to current economic or market factors, this standardization of loan qualifications and other lending procedures helped reduce or eliminate much of the variation in loan quality, types of loan programs offered, and aspects of home loans that were made in different parts of the country. These underwriting standards also create some degree of confidence in purchasers of the mortgage-backed securities. The purchasers know that the mortgages backing the securities must be of a minimum quality, lessening their risk in investing in properties they can't view or assess.

Oversight of Financial Institutions

Several federal agencies, including HUD and FDIC, as well as state agencies regulate financial institutions, in addition to the Federal Reserve.

Federal Deposit Insurance Corporation

The **Federal Deposit Insurance Corporation** (FDIC) is an independent agency created by the Congress in 1933 to maintain stability and public confidence in the nation's financial system by insuring deposits in banks and thrift institutions; examining and supervising financial institutions for safety, soundness, and consumer protection; and managing receiverships. As of May, 2010, the FDIC insured deposits for nearly 8,000 institutions. The FDIC insures deposits only. It does not insure securities, mutual funds, or similar types of investments that banks and thrift institutions may offer.

The FDIC directly examines and supervises more than half of the banks and savings banks in the banking system for operational safety and soundness. Banks can be chartered by the states or by the federal government. Banks chartered by states also have the choice of whether to join the Federal Reserve System. The FDIC is the primary federal regulator of banks that are chartered by the states that do not join the Federal Reserve System. In addition, the FDIC is the back-up supervisor for the remaining insured banks and thrift institutions.

Office of Thrift Supervision

The **Office of Thrift Supervision** (OTS), a division of the U.S. Department of the Treasury, was established in 1989 to supervise, charter, and regulate federal thrift institutions. Savings banks, savings and loans, cooperative banks, and credit unions classify as thrift institutions (the word "Federal" or the initials "F.S.B." appear in the federal institution's name).

Office of Comptroller of Currency

The **Office of Comptroller of Currency** (OCC) charters, regulates, and supervises all National banks and federal branches/agencies of foreign banks (the word "National" or the initials "N.A." appear in or after the bank's name). It is headed by the Comptroller, who is appointed by the President and is also a director of the FDIC.

National Credit Union Administration

The **National Credit Union Administration** (NCUA) is the independent federal agency that charters and supervises federal credit unions. NCUA, backed by the full faith and credit of the U.S. government, operates the National Credit Union Share Insurance Fund (NCUSIF) which insures the savings of 80 million account holders in all federal credit unions and many state-chartered credit unions.

Federal Financial Institutions Examination Council

The **Federal Financial Institutions Examination Council (FFIEC)** is a formal interagency body empowered to proscribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS), and to make recommendations to promote uniformity in the supervision of financial institutions.

Federal Housing Finance Agency (FHFA)

The Federal Housing Finance Agency is an independent federal agency created by the **Federal Housing Finance Regulatory Reform Act of 2008** (Division A of the larger Housing and Economic Recovery Act of 2008). The purpose of the FHFA is to promote a stronger, safer U.S. housing finance system. To that end, the FHFA has broad powers similar in function and structure to federal banking regulators, including expanded legal and regulatory authority over the secondary mortgage markets and oversight of the 14 housing-related government-sponsored enterprises—including Fannie Mae and Freddie Mac—and oversight of the 12 Federal Home Loan Banks (FHL Banks).

The creation of the FHFA merged the powers and regulatory authority of the former **Federal Housing Finance Board (FHFB)** and the **Office of Federal Housing Enterprise Oversight (OFHEO)**, as well as the GSE mission office at the Department of Housing and Urban Development (HUD). The Federal Housing Finance Board was originally established to regulate the Federal Home Loan Banks that were created in 1932. The Office of Federal Housing Enterprise Oversight was originally established as an independent entity within the Department of Housing and Urban Development by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.

REAL SUCCESS

State banking authorities also regulate financial institutions that operate in their states. Regulations, laws, and procedures for mortgage bankers and mortgage brokers may vary from state to state. Also, it is important to understand the differences in any state, county, or municipal jurisdiction in which you are doing business.

Present Day Mortgage Lending

The creation of Fannie Mae was really the birth of the mortgage industry that we have today. Over the years, changes in the industry, along with rising interest rates and a desire to shift credit risk, caused lenders to place even greater emphasis on the ability to sell their loans. As more and more options became available, the secondary mortgage market, led by Fannie Mae, grew in importance as a source of funds for lenders and a means of readily available capital for potential homeowners at attractive interest rates.

However, the demand for safe, mortgage-backed securities is considered one of the factors that led to the subprime crisis that has caused such upheaval in the global financial world. In order to make more and more residential loans, lenders created many new loan programs that the secondary market players were willing to purchase, some of which had relaxed qualifying standards, such as:

- Requiring little or no income or asset documentation.
- Not considering a borrower's impaired credit or ability to repay the loan.
- Waiving the need for an appraisal to verify value of the property being financed.
- Requiring minimum or no down payment.
- Allowing borrowers to avoid mortgage insurance with a first and second mortgage combined for up to 100% of the value of the property.

In addition, some lenders would offer adjustable rate mortgages (ARMs) that had negative amortization, rate adjustments occurring as often as every six months, and exorbitant interest rate caps. These risky loan programs may have been offered to “subprime” borrowers, those who may have poor credit history, higher debt, lower income, previous bankruptcy, short employment history, and other less than ideal characteristics. While most of these loan programs are no longer offered today, such loans frequently resulted in a high rate of delinquency and foreclosure. When mortgaged-backed securities declined in value, investors quit purchasing them, tightening credit around the world. The impact of such a credit crunch on the current market is significant. For example:

- Available financing for jumbo loans is limited.
- Most high-risk loan programs are no longer available.
- Risk-based pricing continues to be a factor.
- Underwriting guidelines are tightened up.
- Mortgage insurance availability may be restricted.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

The industry continues to evolve. The comprehensive H.R. 4173 was signed into law as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 in July, 2010. It will have significant impact on nearly every aspect of mortgage lending. Of most interest to mortgage loan originators are Title X, designated as the Consumer Financial Protection Act, and Title XIV, designated as the Mortgage Reform and Anti-Predatory Lending Act. The Dodd-Frank Act is expected to change the landscape of the mortgage industry forever. While most of the changes will be phased in over the next few years as rules and regulations are promulgated—and our understanding of these changes will evolve over time—it’s important to introduce this legislation here. Mortgage loan originators are responsible for understanding and complying with the new rules and regulations as they are implemented.

Title X: Consumer Financial Protection Act

Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, designated as the **Consumer Financial Protection Act**, provides broad authority related to rules and enforcement in order to address and prevent what it defines as “abusive” financial practices. It also:

- Provides states with more regulatory authority over federally chartered institutions.
- Imposes additional requirements related to data collection and reporting.
- Mandates studies on certain mortgage-related issues that will likely result in additional legislation.

Section 1011 of Subtitle A of Title X creates a new **Consumer Financial Protection Bureau** (CFPB) whose task is to enforce consumer financial protection laws. While the Bureau is within the Federal Reserve, it is intended to function independently as an Executive agency. The Bureau is charged with supervision, examination, and enforcement over all insured depository institutions and credit unions with assets over \$10 billion; all non-depository institutions that broker, originate, or service mortgage loans; as well as any other provider(s) of consumer services at its discretion, with some exceptions such as auto dealers, attorneys, accountants and tax preparers, and real estate brokerage activities.

Regulatory Authority and Enforcement

The Act consolidates consumer protection responsibilities currently handled by the Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation, Federal Reserve, National Credit Union Administration, the Department of Housing and Urban Development, and Federal Trade Commission under the Consumer Financial Protection Bureau.

The Bureau also has the authority to investigate and conduct hearings on violations of most consumer protection laws. If it determines a violation occurred, the Bureau may issue a cease and desist order or pursue civil action. It has no authority to bring criminal charges, but could refer cases to the Department of Justice and must refer potential tax law violations to the Internal Revenue Service.

Structure of the Bureau

Section 1013 (c)(d)(e)(g) of Subtitle A of Title X creates a number of offices within the Bureau:

- Office of Fair Lending and Equal Opportunity
- Office of Financial Education
- Office of Service Member Affairs
- Office of Financial Protection for Older Americans

As discussed in Section 1013 (b) of Subtitle A of Title X, the Bureau also supports three functional units: Research Unit that provides analysis of trends in consumer financial products, Community Affairs Unit tasked with consumer education and access, and Complaints Unit that will provide website and phone access for collecting and monitoring consumer complaints.

Consumer Advisory Board

Section 1014 of Subtitle A of Title X creates the **Consumer Advisory Board**, which is tasked with advising and consulting with the Bureau in the exercise of its functions under the Federal consumer financial laws, and to provide information on emerging practices in the consumer financial products or services industry, including regional trends, concerns, and other relevant information.

Title XIV: Mortgage Reform and Anti-Predatory Lending Act

Title XIV of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is designated as the **Mortgage Reform and Anti-Predatory Lending Act**. It takes several steps to address what Congress considers to be abusive or predatory lending practices in the mortgage industry. For example, Subtitle B of Title XIV:

- Requires mortgage loan originators to apply new minimum qualifying standards and defines a new category of “qualified” loans.
- Requires verification/documentation of the borrower’s ability to repay the loan.
- Establishes penalties for irresponsible lending, including extended foreclosure defense for borrowers.

Subtitle C of Title XIV expands consumer protection for high cost mortgages.

Some key provisions of Titles X and XIV are discussed below and in later chapters.

Qualified Residential Mortgage (QRM)

The Mortgage Reform and Anti-Predatory Lending Act contains provisions in § 1412 that require financial institutions that securitize mortgages loans to retain an economic interest of at least 5%, although securities backed by loans that meet the criteria of a **qualified residential mortgage (QRM)** will be exempt once final rules are implemented.

The proposed rule—issued by the Federal Deposit Insurance Corporation (FDIC), Department of the Treasury, Federal Reserve System, U.S. Securities and Exchange Commission (SEC) and Department of Housing and Urban Development in March of 2011—defines a qualified residential mortgage as one with the following characteristics:

- 20% down payment required (LTV no greater than 80%)
- Qualifying standards of 28% housing expense ratio and 36% total debt-to-income ratio
- Borrower cannot currently be 30 or more days past due on any debt obligation, regardless of credit score
- Borrower cannot have been 60 or more days past due on any debt obligation in the past 24 months
- Borrower cannot have been through bankruptcy, foreclosure, engaged in short sale or deed in lieu of foreclosure, or subject to federal or state debt judgment in the past 36 month

The Consumer Financial Protection Bureau has 18 months after the transfer of rulemaking authority to promulgate final rules.

Chapter 1 Summary

1. **Mortgages** are written instruments using real property to secure repayment of a debt. Their use in the home purchasing process continues to evolve. The Federal Reserve Act of 1913 created the Federal Reserve, established a federal charter for banks to make real estate loans, and set up a way to influence interest rates. The National Housing Act of 1934 created the **Federal Housing Administration (FHA)** to insure banks against losses for defaults on home loans. The 12 **Federal Home Loan Banks (FHL Banks)** were established in 1932 as regional cooperative banks that U.S. lending institutions use to finance housing and economic development in their communities. The **Federal National Mortgage Association (Fannie Mae)** was created in 1938 as the first secondary market to address the problem of uneven supply of money for mortgage loans.
2. The **primary market** consists of lenders making mortgage loans directly to borrowers. Primary lenders include commercial banks, savings and loans (S & Ls), savings and mutual savings banks, and mortgage companies, which includes mortgage bankers who may originate/fund/service loans, and mortgage brokers who place loans with lenders. S & Ls were once the largest provider of home mortgage loans, but regulation and risky investments left many savings and loans insolvent.
3. The **secondary market** consists of private investors and government entities that buy and sell home mortgages; created to moderate local real estate cycles, give lenders new money to lend again, and standardize loan criteria. The **Federal National Mortgage Association (Fannie Mae)** is the largest investor in residential mortgages, buying and selling **mortgage-backed securities**. The **Federal Home Loan Mortgage Corporation (Freddie Mac)** also issues mortgage-backed securities. The **Government National Mortgage Association (Ginnie Mae)** is government-owned and managed by HUD. Ginnie Mae guarantees payment of principal and interest on government insured or guaranteed loans (such as FHA and VA) for its mortgage-backed securities.
4. In addition to the Federal Reserve, oversight of the mortgage industry includes: **Federal Deposit Insurance Corporation (FDIC)**—insures deposits and examines and supervises financial institutions; **Office of Thrift Supervision (OTS)**—supervises, charters, and regulates federal thrift institutions; **Office of Comptroller of Currency (OCC)**—charters, regulates, and supervises all National banks; the **National Credit Union Administration (NCUA)**—charters and supervises federal credit unions; **Federal Financial Institutions Examination Council (FFIEC)**—formal interagency body empowered to prescribe uniform principles, standards, and make recommendations; **Federal Housing Finance Agency (FHFA)**—legal and regulatory authority over the secondary mortgage markets, Fannie Mae/Freddie Mac, and the Federal Home Loan Banks (FHL Banks).
5. Looser qualifications for home mortgages led to significant increases in borrower default on risky loans, resulting in the so-called **subprime mortgage crisis**. As a consequence, qualification standards are tightening, many laws have been passed related to predatory lending, higher risk loan programs are unavailable, and financing is more difficult to obtain.
6. The **Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010** is a significant overhaul of the nation's financial laws, including those that affect the mortgage industry. Title X of Dodd-Frank, Consumer Financial Protection Act, creates a new **Consumer Financial Protection Bureau (CFPB)** within the Federal Reserve that consolidates broad regulatory authority. Title XIV of Dodd-Frank, Mortgage Reform and Anti-Predatory Lending Act, addresses abusive lending practices. Consumer protection responsibilities currently handled by the Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation, Federal Reserve, National Credit Union Administration, the Department of Housing and Urban Development, and Federal Trade Commission will be consolidated under the CFPB when fully implemented.

Chapter 1 Quiz

1. **Which is NOT a function of the secondary markets?**
 - A. moderate effects of local real estate cycles
 - B. provide lenders with money to make more loans
 - C. serve as a depository for consumer assets
 - D. standardize underwriting guidelines
2. **The Consumer Financial Protection Bureau was created by the**
 - A. Federal Reserve Act.
 - B. Federal Home Loan Bank Act.
 - C. National Housing Act.
 - D. Dodd-Frank Wall Street Reform and Consumer Protection Act.
3. **Which agency is conservator of Fannie Mae and Freddie Mac?**
 - A. Department of Housing and Urban Development
 - B. Federal Housing Administration
 - C. Federal Housing Finance Agency
 - D. Office of Federal Housing Enterprise Oversight
4. **Which is the largest secondary market participant?**
 - A. Federal Home Loan Mortgage Corporation
 - B. Federal Housing Administration
 - C. Federal National Mortgage Association
 - D. Government National Mortgage Association
5. **Mortgage brokers**
 - A. act as intermediaries between borrowers and lenders.
 - B. originate and service mortgage loans.
 - C. provide funding for mortgage loans.
 - D. underwrite mortgage loans.
6. **What was established in 1932 as a cooperative to finance housing in local communities?**
 - A. Federal Home Loan Mortgage Corporation
 - B. Federal Home Loan Banks
 - C. Federal Housing Finance Agency
 - D. Government National Mortgage Association
7. **Which is NOT a primary lender for residential properties?**
 - A. commercial banks
 - B. insurance companies
 - C. mortgage companies
 - D. savings and loan associations
8. **Which statement about Ginnie Mae is TRUE?**
 - A. Ginnie Mae buys loans from commercial banks and mortgage companies.
 - B. Ginnie Mae is a private corporation.
 - C. Ginnie Mae is a participant in the primary market.
 - D. Ginnie Mae guarantees mortgage-backed securities.