“STANDARDS IN THE MORTGAGE LENDING INDUSTRY”

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The current crisis in the mortgage lending industry has far reaching implications for the U.S. housing market, the stock market, and the economy in general. Many lawmakers, law interpreters, business people, and spectators in this situation are calling for the government and industry to bring in tougher lending standards to try to help prevent this situation in the future.

As many historians will note, there are few major crises that are completely unprecedented. Often we fail to look at the lessons of the past when making decisions regarding the future. The housing and mortgage lending industry has a long and varied history in the U.S., and has undergone many changes throughout the last century and a half. As such, it is important to revisit the roles standards have played in these incidents that have shaped the way our homeowners (borrowers), lenders and government interact today.

The first mutual savings associations were developed under state law, nearly a century before a federal mutual charter was created in 1933. The first of these associations in the U.S., the Oxford Provident Building Association of Philadelphia County, was established in 1831. This association was very different from the present day stock corporations in several respects. One of the fundamental distinctions was that the early building and loan associations were based on the concept of complete mutuality. As Dwight Smith, former Deputy Chief Counsel for the Office of Thrift Supervision notes:

> The success of the institution depended solely on the creditworthiness of the investors. The groups of investors and borrowers were identical. In order to be a

> borrower one had to have subscribed for shares, and every subscriber had to take out a loan during the ten-year life of the institution. The order in which subscribers could take out loans was determined by an auction process; the subscriber willing to pay the highest premium would have one of the first loans. Thus a subscriber would be involved in four different transfers of funds: regular payments of principle and interest on the loan; monthly installment payments on the subscription; the receipt of a semi-annual dividend; and the right to receive the par value of the stock when the institution terminated.[1]

A fundamental tenant of this system is that the institution only existed for a fixed period of time. The subscriptions had to be made when the institution first organized, and no offerings were made afterward. As well, the institution only existed for a fixed period of time (in Oxford's case, ten years); at the end of this period, all subscribers would receive all of the credit that was due to them. This idea of a fixed number of subscribers, fixed payments, and fixed term of the association made these original building and loan associations very illiquid.

This standard of complete mutuality endured for nearly forty years, when the interval between subscriptions for shares disappeared. Called the "permanent plan," this variation on the traditional mutual savings association no longer required that subscriptions began when the institution first organized, and as such the term of the institution became variable. All of the information for each subscription was maintained separately, a significant move away from the strict terms of the original Buildings and

[1] Smith, Dwight C. "Mutual Savings Associations and Conversion to Stock Form" May 1997 http://www.ots.treas.gov/docs/4/48801.pdf

Loans. Over the course of three decades, the concept of a single, fixed subscriber base institution gave way to more permanent institutions that offered separate opportunities for subscription at regular intervals, typically yearly. As with many standards, the rules governing this style of institution were created by the industry itself, only later to be formalized by state law.

One variation of this style of institution that became known as the "Dayton plan" emerged in the 1880s, and it would eventually become the model for the federal mutual charter created in 1933. Under this plan, several of the restrictions that were inherent to the original Mutual Savings associations were done away with:

> A Dayton plan institution was able to obtain funds more broadly than other building and loan associations because it permitted subscribers to prepay their shares and to make payments on their subscriptions at any time and in any amount. Further, a Dayton plan institution accepted deposits that, unlike subscriptions, did not carry with them a borrowing obligation. In addition, to the extent a subscription served a purpose as an investment vehicle, the Dayton plan strengthened that feature by allowing withdrawals without substantial penalties…. It was during this period that mutual institutions began to establish reserves for losses.[2]

This last point was an important paradigm shift for building and loan associations. With the previous system, the subscribers came together in a completely mutual system

[2] Smith, Dwight C. "Mutual Savings Associations and Conversion to Stock Form" May 1997 http://www.ots.treas.gov/docs/4/48801.pdf

where all payments, withdrawals, and the effective interest rate were fixed. The Dayton plan enabled subscribers to buy and sell shares of the institution at their will (with reasonable notice) and receive dividends on those shares. This new plan was a significant step toward the idea that building and loan associations could be used as somewhat liquid investment vehicles.

From the introduction of the Dayton plan into the early 1900s, several court decisions cemented the fundamental principle of the modern mutual association; that the net worth of the association belonged to the depositors, but they could not individually exercise the rights of equity shareholders. This was an important step in establishing the ownership of savings and loans by the shareholders, while ensuring the capability of the institutions to operate effectively.

The Dayton plan structure for savings and loan associations remained fairly constant until the enactment of the Home Owners' Loan Act (HOLA) in 1933.[3] Under this act, Congress authorized the Federal Home Loan Bank Board (FHLBB) to "charter federal mutual savings and loan associations to expand the best practices of mutual savings associations to areas not adequately served by state-chartered institutions."[4] In establishing these best practices, the FHLBB maintained the concept of mutuality in savings and loans in that a shareholder in an institution owned a pro-rated portion of the institution and had rights to that portion of the institution's assets "in the event of voluntary or involuntary liquidation, dissolution, or winding up of the association."[5]

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[3] Home Owner's Loan Act of June 13, 1933, ch. 64, § 1, 48. Stat. 128.
[4] Smith, Dwight C. "Mutual Savings Associations and Conversion to Stock Form" May 1997 http://www.ots.treas.gov/docs/4/48801.pdf
[5] Smith, Dwight C. "Mutual Savings Associations and Conversion to Stock Form" May 1997 http://www.ots.treas.gov/docs/4/48801.pdf

The Savings and loan associations continued to flourish as lending institutions throughout the rest of the twentieth century until the 1960s, when a sequence of changes in the standards that govern lending by Savings and Loan Associations started the industry down the road that eventually led to the Savings and Loan (S&L) crisis. While many different issues assisted in creating the perfect storm that led to the "largest and costliest venture in public misfeasance, malfeasance and larceny of all time,"[6] there is a common thread: the gradual eroding of standards.

Beginning in 1966 and continuing through the 1970s, market interest rates became increasingly volatile. Each interest rate increase brought more hardship upon the Savings and Loan industry since the S&L lending standards at the time included interest rate ceilings that prevented the S&L institutions from being able to pay competitive rates on deposits. Therefore,

> Every time the market interest rates rise, substantial amounts of funds are withdrawn by consumers for placement in instruments with higher rates of return. This process of deposit withdrawal ("disintermediation") and the subsequent deposit influx when rates rise ("reintermediation") leaves S&Ls highly vulnerable. Concurrently, money market funds become a source of competition for S&L deposits. S&Ls are additionally restricted by not being allowed to enter into business other than accepting deposits and granting home mortgage loans.[7]

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[6] Pizzo, Steven, et al., "Inside Job." Mcgraw-Hill; 1st Ed. 1989. ISBN 0-07-050230-7

[7] "The S&L Crisis: A Chrono-Bibliography." FDIC Industry Analysis, 20 Dec 2002. http://www.fdic.gov/bank/historical/s&l/

In 1980, the Federal Home Loan Bank Board reduced the net worth requirement for insured S&Ls from 5 to 4 percent of total deposits and removed the limit on the amounts of brokered deposits an S&L can hold. This is the first of a string of weakening of the governing standards that, in an attempt to make the S&L more able to cope with the losses it was taking, placed the industry in a position to overextend itself. In 1981, "the Federal Home Loan Bank Board permitted struggling S&Ls to issue 'income capital certificates' that are purchased by the [Federal Savings and Loan Insurance Corporation] and included as capital. Rather than showing that an institution is insolvent, the certificates make it appear solvent."[8]

In 1982, the Federal Home Loan Bank Board further reduced the net worth standard for insured S&Ls from 4 to 3 percent, and allowed them to meet this requirement using the more liberal regulatory accounting principles (RAP) standard instead of the generally accepted accounting principles (GAAP) standard. Once again, the weakening of the standards was felt to be justified by the dire situation the S&Ls were facing at the time. Further eroding the safeguards in place,

> The Bank Board eliminates restrictions on minimum numbers of S&L stock holders. Previously, it required at least 400 stock holders of which at least 125 had to be from "local community", with no individual owning more than 10% of stock and no "controlling group" more than 25%. [The] Bank Board's new ownership

[8] "The S&L Crisis: A Chrono-Bibliography." FDIC Industry Analysis, 20 Dec 2002. http://www.fdic.gov/bank/historical/s&l/

> regulation would allow a single owner. Purchases of S&Ls were made easier by allowing buyers to put up land and other real estate, as opposed to cash.[9]

This incremental weakening of standards in the S&L industry, coupled with a failure of oversight by the Bank Board created an environment in allowed the industry to continue to become more and more leveraged. From 1986 until 1989, the S&Ls continued to compounded losses. Eventually, in a final act to completely resolve the problem of downwardly spiraling standards, newly elected President Bush introduced the S&L bailout plan, leading to the Financial Institutions Reform Recovery and Enforcement Act (FIRREA). The FIRREA, among other things, abolished the Federal Home Loan Bank Board and FSLIC, moved S&L regulation to the newly created Office of Thrift Supervision, placed deposit insurance under the Federal Deposit Insurance Corporation (FDIC), and created the Resolution Trust Corporation to resolve the insolvent S&Ls. Additional provisions of the FIRREA include:

> $50 billion of new borrowing authority, with most financed from general revenues and the industry; meaningful net worth requirements and regulation by the OTS and FDIC; [and] allocation funds to the Justice Department to help finance prosecution of S&L crimes. Additional bank crime legislation the next year (i.e., the Crime Control Act of 1990) mandates a study by the National Commission on

[9] "The S&L Crisis: A Chrono-Bibliography." FDIC Industry Analysis, 20 Dec 2002. http://www.fdic.gov/bank/historical/s&l/

Financial Institution Reform, Recovery and Enforcement to uncover the causes of the S&L crisis and come up wit recommendations to prevent future debacles.[10]

In total, the S&L crisis cost the American public an estimated $175 billion, largely due to the relaxation of standards and a failure to enforce standards. There are several parallels between the S&L crisis and the current subprime lending crisis. According to the Federal Reserve, subprime mortgages, those mortgages that are entered into with borrowers whose credit scores do not meet a minimum standard, "nearly tripled during the housing boom years of 2004 and 2005."[11] Due to decelerating house prices, rising interest rates and slower economic growth, delinquency among subprime borrowers has increased greatly. In a speech given to the International Monetary Conference in 2007, Federal Reserve Board Chairman Ben Bernanke reported:

> Some of the increased difficulties now being experienced by subprime borrowers are likely the result of an earlier loosening of underwriting standards, as evidenced by the pronounced rise in 2006 in "early payment defaults"—defaults occurring within a few months of mortgage origination…. As a consequence of these developments, investors are now scrutinizing nonprime loans more carefully, and lenders in turn have tightened up their underwriting."[12]

[10] "The S&L Crisis: A Chrono-Bibliography." FDIC Industry Analysis, 20 Dec 2002. http://www.fdic.gov/bank/historical/s&l/
[11] Bernanke, Ben S. "The Housing Market and Subprime Lending." Speech to the 2007 International Monetary Conference, Cape Town, South Africa (via Satellite) June 5, 2007. http://www.federalreserve.gov/BoardDocs/Speeches/2007/20070605/default.htm
[12] Ibid.

It is clear from the data that loose lending standards have resulted in loans being made to borrowers with terms that have a higher than desired likelihood of causing the borrower to default on the loan. This is precisely the scenario that lending standards are in place to prevent. However, there is often a trade off when establishing standards. In general, the establishment and enforcement of well written standards will typically be beneficial to all interested parties- industry, government and public. However, it is entirely possible, as some critics of lending standards reform argue, that a tightening of the lending standards will cause harm, denying opportunities for home ownership to those who need it the most: those with less than perfect credit.

Some critics of standards reform in the lending industry claim that the standards are in place to enable lenders to appropriately lend to borrowers, and that a tightening will only serve to hinder the good faith efforts of those lenders that are striving to extend loans to those who might not otherwise be able to buy a house. Chairman Bernanke explains,

> We at the Federal Reserve, other regulators, and the Congress are evaluating what actions may be needed to prevent a recurrence of these problems. In deciding, we must walk a fine line: We have an obligation to prevent fraud and abusive lending; at the same time, we must tread carefully so as not to suppress responsible lending or eliminate refinancing opportunities for subprime borrowers.[13]

[13] Bernanke, Ben S. "The Housing Market and Subprime Lending." Speech to the 2007 International Monetary Conference, Cape Town, South Africa (via Satellite) June 5, 2007. http://www.federalreserve.gov/BoardDocs/Speeches/2007/20070605/default.htm

The statement that standards are already in place that will prevent the lenders from extending credit to those borrowers who truly are not financially secure enough to carry the loan certainly implies that this crisis is solely due to a combination of lender ignorance of the standards, or lender abuse of the standards. Both of these issues represent real problems that are similar to those that we have seen in the past with the Savings and Loan fiasco. The question becomes now, are there standards in place to ensure that the lending standards are being adhered to, and what precisely are the lending standards?

Freddie Mac, chartered by congress in 1970, is one of America's biggest buyers of mortgages, providing liquidity and standardization to the mortgage lending industry. In response to the subprime mortgage crisis, Freddie Mac has tightened its standards for mortgages bought on the secondary market, which pressures the primary lenders to enforce these standards if they are to sell to Freddie Mac.

> Freddie Mac's new requirements cover what are commonly referred to as 2/28 and 3/27 hybrid ARMs, which currently comprise roughly three-quarters of the subprime market. Specifically, the company is requiring that borrowers applying for these products be underwritten at the fully- indexed and amortizing rate, as opposed to the initial "teaser" rate. The company also will limit the use of low-documentation products in combination with these loans. For example, the company will no longer purchase "No Income, No Asset" documentation loans and will limit "Stated Income, Stated Assets" products to borrowers whose incomes derive from hard-to-verify sources, such as the self-employed and those

in the "cash economy." There will be a reasonableness standard for stated incomes. [14]

Freddie Mac's efforts are focused on the enforcement of more conservative lending practices, and the trickle down effect that their internal standards will have on the standards that the primary lenders with whom they deal choose to employ. This appears to be one viable approach aimed primarily at those lenders who simply are too relaxed in their lending standards. However, there still exists the issue of malicious and purposeful unfair lending practices that may take on higher risk of default even while meeting certain standards.

Unfair lending practices that take advantage of borrowers, setting them up for failure, have been observed throughout the industry. Some of the most common practices are offering loans based on insufficient knowledge of the borrower's ability to repay the debt, qualifying borrowers for a loan based on "teaser" rates that are much lower than the true rate of the loan, and offering high cost loans to borrowers not on the basis of credit worthiness but on other factors, such as race and gender. The National Community Reinvestment Coalition, a trade association formed in 1990 to bring "economic justice" to traditionally underserved communities using local organizations, writes:

> In the backdrop of the risky high-cost lending practices, NCRC observes striking racial disparities in high-cost lending. If a consumer is a minority, particularly an

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[14] Freddie Mac Announces Tougher Subprime Lending Standards to help reduce the risk of future borrower default." Freddie Mac Press Release, 27 Feb 2007.
http://www.freddiemac.com/news/archives/corporate/2007/20070227_subprimelending.html

> African-American or a Hispanic, the consumer is most at risk of receiving a poorly underwritten high-cost loan. In addition, middle-class or upper-class status does not shield minorities from receiving dangerous high-cost loans. In fact, NCRC observes that racial differences in lending increase as income levels increase. In other words, middle- and upper-income (MUI) minorities are more likely relative to their MUI white counterparts to receive high-cost loans than low- and moderate-income (LMI) minorities are relative to LMI whites.[15]

The question still remains, what exactly are the standards for lending and what body is responsible for setting, reviewing, and enforcing these standards? As generally evidenced by the amount and types of abuse occurring in the lending industry, the answers are somewhat murky. The Mortgage Bankers Association (MBA), the national association representing the real estate finance industry, provides the following:

> MBA members endorsing these "Best Practices" agree to conduct their business according to standards outlined below. These standards are meant to serve as guidelines by which our members will meet their business goals and objectives while providing fair and equitable treatment to consumers. To ensure compliance, members who adopt these best practices also agree to annual self-certifications with verification by credible independent third parties…. Members will comply with all applicable state and federal laws and regulations, including, but not

[15] "Income is No Shield Against Racial Differences in Lending," NCRC, 2007 http://www.ncrc.org/pressandpubs/documents/NCRC%20metro%20study%20race%20and%20income%20disparity%20July%2007.pdf

limited to: The Equal Credit Opportunity Act; The Fair Housing Act; The Fair Credit Reporting Act; The Truth in Lending Act; The Real Estate Settlement Procedures Act.[16]

Unlike many industries in which the industry members come together to create standards in order to provide for compatibility and safety of the products created, the lending industry has no need for this style of standard setting. The only compatibility requirements imposed on the individual lenders come from the secondary market (i.e., from corporations such as Freddie Mac and large hedge funds who buy and sell securitized mortgages).

Thus, the MBA relies on legislation to establish firm standards for lending, while issuing guidance in the form of best practices for the industry. The enforcement of the standards does not reside within the industry, but in the form of federal and state law. Outside of meeting the applicable laws regarding the disclosure of information and a minimum amount of investigation into a potential borrower's credit worthiness, primary lenders generally have wide latitude in offering loans.

It is therefore left to legislation to set minimum standards for lenders, and to revise these standards at appropriate intervals. Unfortunately, calls for revisions usually only come in times when the level of abuse has gotten to levels high enough to garner national attention. This was ultimately the course of action toward the end of the S&L crisis and into the aftermath. Now, as in the past, legislation has been introduced that will attempt to enact measurable standards that must be met when making loans to

[16] "MBA Best Practices." Mortgage Bankers Association, 2007 http://www.mortgagebankers.org/IndustryResources/StandardsandBestPractices/MBABestPractices.htm

borrowers. In response to the current subprime lending crisis, Senator Schumer has introduced a bill that will codify certain best practices in the industry. Of specific note is the language that defines a previously gray area, that of the prospective borrower's ability to repay the loan:

> (1) IN GENERAL.—Each mortgage originator shall, before entering into or otherwise facilitating any home mortgage loan, verify the reasonable ability of the borrower to pay the principal and interest on the loan, and any real estate taxes and home owners insurance fees and premiums.
>
> (2) VARIABLE MORTGAGE RATES.—In the case of a home mortgage loan with respect to which the applicable rate of interest may vary, for purposes of paragraph (1), the ability to pay shall be determined based on the maximum possible monthly payment that could be due from the borrower during the first 7 years of the loan term, which amount shall be calculated by—
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> (A) using the maximum interest rate allowable under the loan; and
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> (B) assuming no default by the borrower, a repayment schedule which achieves full amortization over the life of the loan.[17]

This is likely to be only one of several legislative standard-setting items that will attempt to reign in abusive lending. However, as we have seen in the past in an industry that does not necessarily profit from cooperatively derived internal standards, these new

[17] Proposed "Borrower's Protection Act of 2007." S.1299, 2007 http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:s1299is.txt.pdf

laws may correct the short term situation but will most likely fail to fully protect the economy of the U.S. from lending failures in the future.

From the early days of the Mutual Building and Loan Associations to present day, the lending industry has generally experienced a continuing trend of enacting only mildly restrictive standards that are difficult to enforce. The abuses, fraud and discriminatory practices are born of the desire to allow the industry to govern itself within the framework of federal and state law. These issues will not vanish; the best the industry can hope for is that they will recede until the next set of economic conditions allows them to make their reappearance.

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