

# Washington Wakes Up to Nightmare Mortgages

Remarks of

Karen Shaw Petrou  
and  
Basil N. Petrou

Federal Financial Analytics, Inc.

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It is indeed a pleasure to join you all at this lovely setting. It's hard to think ill of anything as one looks out at the glorious beach below these meeting rooms, but the tide is running against the mortgage and housing finance markets as we speak. This is, of course, not news to any of you. What we hope to add to your understanding of the market is the role Washington legislation and regulation will play in it during coming months. The housing market is riddled with debris from those who didn't see changing regulatory, capital and tax rules coming – one need only remember the 1986 tax law changes to recall a particularly stark example of Washington's impact. We don't see anything like that in the works, but there are some very significant changes afoot with far-reaching market impact we would like to discuss this morning.

In fact, there are so many of these important changes under way that time will permit only a very short discussion of some of the most important ones. We'll take turns talking about them, and we'll be happy to answer any questions about the developments we discuss and any others in which you are interested. Briefly, we'll touch on the array of new bank regulatory actions – most notably the pending guidance on non-traditional mortgages and commercial real estate and the Basel rules. We'll then turn to Capitol Hill, focusing in particular on where the contentious GSE-reform bill stands as we speak.

## What the Regulators Are Up To

### **Non-Traditional Mortgages**

Perhaps the most important – not to mention imminent – regulatory action with far-reaching market impact is pending inter-agency guidance on non-traditional mortgages, sometimes more politely called alternative mortgages or, less so, exotic ones. The agencies put out tough proposed guidance last December and there it has lain under a barrage of industry criticism. Or, so it remained until a joint hearing of two Senate Banking Subcommittees last Wednesday subjected the banking agencies to withering criticism for not acting tough enough or fast enough.

We think final NTM guidance will be out by mid-October and it will be pretty much as proposed. Importantly, it will cover not only originations, but also sales to the secondary market – a boon, we think to Fannie and Freddie's declining market-share since lenders will return to more conventional, conforming loans. This should also be a boost to private mortgage insurers, since the new guidance doesn't like piggyback mortgages and subjects them to an array of sanctions, especially when the second is layered into a high-risk mortgage product.

You may rightly be skeptical about the real market impact of the NTM guidance in light of the slight dent, if any, made by last year's second-lien guidance. However, the Senate told the regulators in no uncertain terms to enforce the new guidance and the regulators solemnly promised to do so. Non-bank regulators at the state level – and, we think, the FTC – are also about to weigh in, although their ability to issue meaningful standards is more questionable and, thus, their market impact less clear.

## **Commercial Real Estate**

What Congress took from the industry on the NTM guidance, it gave on the CRE one. The regulators proposed tough new standards here last January, again receiving a blizzard of bad news from the industry in response. On September 14, the agencies were hauled before the House Financial Institutions Subcommittee to explain just why they took so dim a CRE view, with Members taking particular issue with the proposed curbs on multi-family lending.

Our guess is that this guidance went back to the drawing board after the hearing. The Office of Thrift Supervision was always a reluctant participant in these supervisory initiatives, but it flatly disavowed the CRE one in the course of the hearing. It will take a long time to get everyone back to the table and, when they get there, a lot of work will be done to differentiate different CRE categories.

We thus expect a CRE crack-down sometime next year when the final guidance comes out. Importantly, though, the tenor of the hearing could provide some relief to lenders, especially small and mid-sized ones, right now. When the CRE guidance was first proposed, a lot of examiners went out and pressed banks quickly to come into compliance – which meant a lot of hurt for a lot of banks. The top regulators told Congress that examiners shouldn't be acting this way, giving bankers ammunition to go back to their individual bargaining tables and, perhaps, keep on going in a variety of still-hot CRE arenas.

## **Basel Rules**

Time doesn't permit a detailed discussion of the Basel rules – indeed, weeks don't permit it. However, we want to be sure you know that the U.S. Basel rules are on indefinite hold even as they go into effect everywhere else on January 1. This means that foreign banks will get a big break on regulatory capital related to mortgages and many may use it to favorable advantage in the U.S. mortgage market. U.S. regulators are increasingly distressed that the Basel I rules still in effect here create incentives for high-risk mortgages – part of the reason for the NTM guidance, of course.

The U.S. regulators are now between the proverbial rock and hard place: the current regulatory capital rules don't work and the new ones are far from appealing to key constituencies, Congress included. As a result, we expect the regulators to press gamely ahead with the Basel IA and II rulemakings, but increasingly focus on specific problems

in the current rules and revise capital or prudential standards on a case-by-case basis. Throughout this, they'll keep the 5% leverage standard in place. We'll talk a bit later about OFHEO and new risk-based capital rules for Fannie and Freddie. But, for as long as the banks are under Basel I and leverage, the better the GSEs will look

The Basel brou-ha-ha also plays an important role in the growing number of non-bank acquisitions of bank mortgage lenders. In two recent cases, Merrill Lynch and Morgan Stanley have done big deals. Each of these firms is a "consolidated supervised entity" under SEC capital standards that are similar to Basel II – although importantly there is no leverage standard. To the degree mortgage lending moves from bank to non-bank, it is not only exempt from the NTM guidance – at least for now – but also from punitive capital rules. This gives them, we think, a very interesting edge.

### **GSE Regulatory Developments**

Time doesn't permit any detailed discussion of key emerging issues here. Also, we don't want to focus too much on what OFHEO or the Federal Housing Finance Board might do because – depending on the legislative outcome we'll get to in a minute – much of this could be moot. However, several important current developments that affect relative competitiveness and market function include:

- an FHFB rule tightening up on Federal Home Loan Bank "excess" stock and retained earnings. This could have far-reaching impact, but it's already contributing to the new U.S. covered bond market;
- OFHEO risk-based capital standards for Fannie and Freddie, which even under current law could significantly alter their business mix; and
- tough new OFHEO restraints on GSE ventures, including the Fannie Mae patent. However, this patent is on the books, creating serious licensing and/or product constraint concerns for everyone in the mortgage business.

### **Up On The Hill**

With the mid-term elections in the offing – and, of course, of potential profound impact on who controls the next Congress – we won't talk today about legislation to come. The most critical issue confronting us now is, of course, the massive rewrite of GSE regulation teetering on a precipice at the close of the 108<sup>th</sup> Congress. Maybe we're outliers, but we think a bill will be sent to the President before the year is out. Treasury is certainly pushing the GSEs to get them to the table. We draw your attention to comments last week from Assistant Secretary Emil Henry proclaiming possible sanctions – the debt limit at the top of the list, we think – if a bill isn't done this week.

All of the key parties to a bill – with the possible exception of Sen. Sarbanes – are at the table and bargaining hard. The key problem spots are, as you all know, the portfolio limit and affordable-housing language. The latter is, we think, pretty easy to resolve, with Rep. Barney Frank and Sen. Jack Reed close to a compromise with Republicans on this if one isn't already complete. The Administration's stand on the portfolio is hinged on controls related to systemic risk, which Democrats fear could be a loaded cannon permitting the new regulator to force the portfolio to a pittance. We think this too will be resolved, although we've seen more than enough legislation slip away at the end to make this bet with diffidence and humility.

We'd like to address during questioning the specifics of the GSE reform bill on other critical points – the future of the Home Loan Banks, for example. We've also put a lot of other important issues in your hand-out without addressing them in our talk. So, we'd like now to turn to your questions and see if we can help with some answers or, at least, our opinion.