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**Presenter:**

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# HISTORY OF MORTGAGE FINANCE WITH AN EMPHASIS ON MORTGAGE GUARANTEE INSURANCE

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The views expressed herein are those of the author and do not necessarily represent those of the FHA or HUD. Moreover, for ease of exposition, many quotation marks have been omitted. All of these have been, hopefully, attributed correctly in the text of the full report found on the SOA website. The complete text of the underlying paper is available at <http://www.soa.org/library/monographs/finance/housing-wealth/2009/september/mono-2009-mfi09-herzog-history.pdf>

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## Historical Overview -- Philosophical

Event	Republican/Federalist	Democrat/Farmer
First Bank of US	Hamilton	Jefferson/Madison
Second Bank of US	Biddle	Jackson
Creation of OCC	North	South
Creation of Fed	Aldrich	Glass
New Deal Legislation	Lodge	FDR
Deregulation/Housing Bubble	Wall Street (Rubin/Gramm/Greenspan)	Main Street

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## History of Financial Panics in US

Panic	Main Reason(s) for Panic
Panic of 1797	The deflation of the Bank of England caused a huge disruption in the commercial and real estate markets in the U.S.
Panic of 1819	Speculation in Frontier Land; failure to re-charter First Bank of US; lack of an "elastic" money supply
Panic of 1837	Speculation in canals, railroads, slaves; crop failure; "wildcat banks"; closure of Second Bank of U.S.
Panic of 1857	Failure of NYC branch of Ohio Life Insurance and Trust Co.; falling grain prices; land speculation.
Panic of 1873	Speculation in railroad tracks, mines, factories, grain fields; Over-lending by banks
Panic of 1893	Speculation in railroads. (Similar to recent hi-tech bubble in US)
Panic of 1907	Failed attempt to corner copper market; Panic on Wall St., "runs" on banks; identified need for an "elastic" currency which would allow increases in money supply to stop "runs" on banks. J.P. Morgan comes to rescue.
Panic of 1920	Sharp deflationary period (18 months) caused by end of WW I -- followed by rapid recovery.

## US Financial Crises – Last 80 Years

Great Depression	End of Roaring Twenties
Recession of 1937	Cutback in Federal spending
Recession of 1957 (Mild)	Inventory Build-up, Decline in Corporate Spending
Technology Bubble of 1970	Rampant Speculation in Technology Stocks
Recession of 1973	Oil Shock from OPEC
Recession of 1981	Volcker – Tight Monetary Policy
Recession of 1991	Savings & Loan Crisis
Technology Bubble of 2000	Rampant Speculation in Technology Stocks
Housing Bubble of 2007	Predatory Lending/Irrational Exuberance

## Financial Regulation/Deregulation

New Regulation	Deregulation
Securities Act of 1933	Garn-St. Germain Depository Institutions Act of 1982
Securities Exchange Act of 1934	Secondary Mortgage Market Enhancement Act of 1984
Banking Act of 1933 (Glass-Steagall)	1986 Tax Reform Act
Banking Act of 1935 (Second Glass-Steagall)	Gramm-Leach-Bliley Financial Modernization Act of 1998
Bank Holding Company Act of 1956	Commodities Future Modernization Act of 2000

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## Mortgage Guarantee Insurers in US

Year	EVENT
1887	Title and Guarantee Company of Rochester, NY founded
1893	Lawyers' Mortgage Insurance Company founded
1904	Four Companies Operating in NY
1930	Fifty Companies Operating in NY
1934	Federal Housing Administration (FHA)
1944	FHA and VA
1957	MGIC begins operating as first new PMI since Depression
1980	Fourteen Operating PMIs
2009	Seven Operating PMIs plus Essence (a new entrant funded by Goldman-Sachs, JP Morgan, and others)

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## EARLY HISTORY

- First Bank of US
  - Chartered 1791-1811
- War of 1812
- Second Bank of US
  - Chartered 1816-1836 (Biddle vs. Jackson)
- Panic of 1837
- Civil War – about 1,500 state-chartered banks
- Office of Comptroller of Currency (est. 1863)
  - Nationally Chartered Banks

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## EARLY 20-TH CENTURY

- Panic of 1907
- National Monetary Commission (Nelson Aldrich)
- Federal Reserve Act of 1913 – Carter Glass
  - Established a **system** with a weak central bank leaving power with the 12 regional banks
  - Does not include deposit insurance

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## Reasons Deposit Insurance Would Not Work

- Defunct state-level deposit insurance programs did not work
- Would remove penalties for bad management
- Would be too expensive
- Would represent an unwarranted intrusion of the Federal government into the private sector.

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## ROARING TWENTIES

- Laissez-faire economic system
- Coolidge: “After all, the chief business of the American people is business. They are profoundly concerned with producing, buying, selling, investing and prospering in the world.”
- Hoover promised “A chicken in every pot and a car in every garage.”
- Rampant speculation and excessive leverage on Wall Street

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## Economy under Hoover

- Stock Market Crashed
- Unemployment Rate Reached 25%
- Reconstruction Finance Corporation (1932)
- Federal Home Loan Bank Act (1932)

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## New Regulation Under New Deal

- Securities Act of 1933
- Securities Exchange Act of 1934
- Banking Act of 1933 (Glass-Steagall)
- Banking Act of 1935 (second Glass-Steagall)

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## Securities Act of 1933: Main Provisions

- It requires that investors receive financial and other significant information concerning securities being offered for public sale. (This deprived bankers of their monopoly on such information.)
- It prohibits deceit, misrepresentations, and other fraud in the sale of securities to the public.

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## Securities Exchange Act of 1934

- Created the Securities and Exchange Commission (SEC)
- Empowered the SEC with broad authority over all aspects of the securities industry. This includes the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation's securities self-regulatory organizations.
- Identifies and prohibits certain types of conduct [e.g., anti-fraud] in the markets.
- Provides the SEC with disciplinary powers over regulated entities and persons associated with them.
- Empowers the SEC to require periodic reporting of information by companies with publicly traded securities.

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## Securities Exchange Act of 1934 (Margin Requirements)

- Gave the Federal Reserve Board the power to regulate margin requirements on the purchase of common stocks. The idea here was to reduce the amount of leverage by requiring the purchaser to use a sizable portion of his/her cash to purchase such assets instead of relying on borrowed funds. The original margin requirement on common stocks was set at 50 percent and became effective on Oct. 1, 1934. The amount has been reset at various times, but in recent years, the Federal Reserve has maintained a 50 percent margin requirement with a \$2,000 minimum.

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## Banking Act of 1933 (Glass-Steagell Act)

- Established the Federal Deposit Insurance Corporation (FDIC) as a temporary federal agency. (It became a permanent agency in 1935.)
- Separated commercial banks (those that accept deposits and lend money) from investment banks (those that underwrite securities), establishing them as separate lines of commerce.

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## The FDIC had two goals.

- To insure bank deposits and to thereby totally eliminate runs on all of the commercial banks in the United States — be they member or non-member banks, National-chartered banks or state-chartered banks.
  - “The certainty that money could be got, took away all desire to have it.” (See Andreades [1909;page 336].)
- To reduce the disruptions to the U.S. economy engendered by bank failures.

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## Initial FDIC Insurance Limit

- Effective on Jan. 1, 1934, individual accounts were insured for amounts up to \$2,500.
- In 1935, this limit was increased to \$5,000.
- The limit is currently \$250,000.

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## Reasons for Separating Commercial Banks from Investment Banks

- To remove/prevent “excessive concentration of financial power” in a small number of large entities. (“Too big to fail” syndrome)
- To keep naïve investors who want to place their funds in (what are today called) money-market accounts “from being sold risky investments” instead.

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## The Bank Holding Company Act of 1956

- This legislation additionally prohibited commercial banks from performing insurance underwriting.
- It also prohibited bank holding companies that owned two or more banks from buying banks in another state.
- These additional prohibitions were again aimed at removing/preventing “excessive concentration of financial power” in a small number of large entities.

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## Banking Act of 1935 (Second Glass-Steagall Act)

- Increased FDIC limit to \$5,000.
- Required the FDIC to prohibit the payment of interest on demand deposits [i.e., checking accounts] in insured nonmember banks and to limit the rates of interest paid on savings and time deposits.
- Required the FDIC to prohibit insured nonmember banks from paying any time deposit before its maturity except as prescribed by the FDIC.
- In granting these and other regulatory powers to the FDIC, Congress sought to prevent unsound, cut-throat competition among banks. The prevailing philosophy was that **unfettered competition** in the past had resulted in excesses and abuses in banking as well as in other industries. The restrictive powers contained in the Banking Act of 1935 were thus consistent with the tenor of other New Deal legislative programs.

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## BANKING REGULATORY AGENCIES AND THEIR FUNCTIONS

Regulatory Agency	Year Created	Created to Regulate	Supervision/Examination	Deposits Insured by
State Agencies	Varies by State	State Banks and S & Ls	State Banks and S & Ls	
OCC	1863	National Banks	National Banks	FDIC
FRB	1913	National and State-member Banks	State-Member Banks	FDIC
FHLBB	1932	S&Ls	S&Ls	FSLIC from 1934
FDIC	1934	State Non-Member Banks and State-Chartered Mutual Savings Banks	State Non-Member Banks and State-Chartered Mutual Savings Banks	FDIC
NCUA	1935	National Credit Unions	All Insured Credit Unions	NCUSIF
OTS	1989	Federal Savings Associations and	Federal Savings Associations and Mutual	FDIC

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## Nature of Mortgage Insurance

- Risk Insured: Inability of borrower to pay mortgage
- Nature of Risk:
  - Economic/Social
  - Not generally diversifiable although wide geographic diversification can help.
  - Similar to unemployment insurance or deposit insurance.
  - Unlike life insurance where risk can be spread.

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## Origins of Private Mortgage Insurance in NY

- Title and Guarantee Company of Rochester, New York (1887)
- Lawyers' Mortgage Insurance Company (1893)
- Prior to 1904, there were a total of four private mortgage guarantee insurance companies operating in New York state even though an intensive study by Alger [1934; page 13] concluded that the New York state legislature had not contemplated giving such companies authority to do “anything more than the guarantee of titles.”<sup>24</sup>

## Alger[1934] on the Risk Inherent in Mortgage Guarantee Insurance

- “It must have been obvious to anyone who ever considered that matter, that any substantial losses by a mortgage guarantee company would be caused by a general depression in the real estate market which would weaken all mortgages and render them for a time at any rate illiquid.”

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## FHA Single-family Mortgages The Early Years

- Fully amortizing mortgages with a (fixed) annual contract interest-rate of 5.5 percent.
- Required a minimum down-payment of 20 percent of the appraised value of the property.
- Had a maximum term of 20 years.
- Had a maximum mortgage amount of \$16,000.
- The annual mortgage insurance premium was 0.5 percent of the original amount of the loan.

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## Steagall National Housing Act of 1938 Changed FHA Underwriting Standards

- For homes costing no more than \$6,000, the maximum loan-to-value ratio was increased from 80 percent to 90 percent.
- For homes costing between \$6,000 and \$10,000, the maximum loan-to-value ratio was increased to 90 percent of the first \$6,000 and 80 percent of the remainder.
- The maximum term was increased from 20 years to 25 years.
- The annual mortgage insurance premium was reduced from .5 percent to .25 percent of the original amount of the mortgage.
- The nominal annual interest rate of the mortgage was reduced from 5.5 percent to 5 percent.

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## FHA – The First Twenty Years

- From its inception in 1934 through Dec. 31, 1954, the **FHA insured a total of 2.9 million mortgages** with an average principal amount of about **\$6,300** per property.
- Through Dec. 31, 1954, 9,253 properties had been foreclosed upon; FHA acquired 5,712 of these properties and paid insurance claims on them. Of these 5,712 properties, 5,282 had been disposed of by Dec. 31, 1954, resulting in a net loss to FHA of \$3.0 million or **an average loss of only \$562 per property acquired and disposed of.**

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## More on FHA's First Twenty Years

- From its inception through June 30, 1954, the MMIF had income of \$494 million and expenses of \$246 million.
- As of June 30, 1954, the MMIF's accumulated statutory reserves and earned surplus totaled \$192 million.

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## VA Home Loan Guarantee Program

- The VA Home Loan Guaranty Program was authorized by The Servicemen's Readjustment Act of 1944 — commonly known as the GI Bill of Rights.
- It was initiated to help veterans returning to the United States from WWII purchase single-family homes and to help stimulate the post-war economy.
- Since its inception in 1944, the VA has guaranteed more than 18 million mortgages.

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## Initial (1944) Underwriting Criteria for VA Guarantee Program

- The maximum amount of guaranty was limited to 50 percent of the loan up to a maximum of \$2,000.
- Loans were limited to a maximum term of 20 years.
- The maximum interest rate was 4 percent.
- There was no guarantee fee (or mortgage insurance premium).

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## Initial VA Funding Fee

- In 1966, for the first time, the VA imposed a funding fee (i.e., a mortgage insurance premium) of one half of one percent of the face amount of the loan.
- The income from this fee was used to establish a reserve fund to cover claim payments incurred under this program.
- This funding fee was discontinued effective Oct. 23, 1970.

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## VA Funding Fee – Reprise

- Effective on October 1, 1982, the VA re-imposed its funding fee of one half of one percent of the face amount of the loan.
- During 1984, the VA funding fee was increased to one percent of the face amount of the loan.

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## Variable VA Funding Fee

Effective for Loans Closed on or after January 1, 1990

Funding Fee as a Percentage of Original Mortgage Amount	Down-payment as a Percentage of Original Mortgage Amount
1.25%	<5%
0.75%	≥5% but <10 %
0.50%	≥10%

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## Creation of Fannie Mae (Federal National Mortgage Association)

- Title III of the original National Housing Act of 1934 authorized “the establishment of national mortgage associations ... (1) to purchase and sell first mortgages ... and (2) to borrow money for such purposes through the issuance of notes, bonds, debentures, or other such obligations.”
- Fannie Mae was chartered in 1938 as the first such national mortgage association. Fannie Mae was also set up as a government agency.
- Although initially limited to FHA loans, Fannie Mae was tasked with expanding the supply of credit beyond depository institutions which both originated mortgages and held them in their portfolio.

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## More on Fannie Mae

- After World War II, Fannie Mae’s authority was extended to mortgages guaranteed by the Veterans’ Administration.
- FNMA created the mortgage banking industry — a new source of mortgage loans — that competed with savings banks and commercial banks.
- In 1954, Fannie Mae was restructured as a mixed ownership (part government, part private) corporation.

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## Splitting of Fannie Mae

- The Housing and Urban Development Act of 1968 directed that Fannie Mae be split into two pieces — Ginnie Mae and a new Fannie Mae.
- The split-off was done for budgetary reasons — to raise money to help pay for the Vietnam War and President Johnson's Great Society initiatives.
- Fannie Mae's transformation to private ownership was completed during 1970. "Using the proceeds from the sale of subordinated debentures, Fannie Mae paid the Treasury \$216 million for the government's preferred stock, which was retired, and for the Treasury's interest in the corporation's earned surplus. As a result, Fannie Mae, now a GSE, was taken off the Federal budget.

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## Ginnie Mae

### (Government National Mortgage Association )

- A wholly owned government corporation within HUD.
- Tasked with supporting the market for mortgages that are originated by private institutions and insured by
  - FHA,
  - HUD's Office of Public and Indian Housing,
  - Department of Veterans' Affairs (VA) Home Loan Program for Veterans, or
  - U.S. Department of Agriculture's Rural Development Housing and Community Facilities programs.

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## Operation of Ginnie Mae

- Ginnie Mae fulfills its mission by guaranteeing the timely payment of principal and interest on collections (or pools) of such mortgages. These are called mortgage-backed securities.
- Ginnie Mae developed and guaranteed the first mortgage-backed security in 1970.
- In exchange for this guarantee, GNMA charges an annual guaranty fee — of 6 basis points or, equivalently, .06 percent of the aggregate outstanding balance of the non-defaulted portion of the issuer portfolio.

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## GINNIE MAE ACTIVITY

- From its inception in 1970 through September 30, 2008, GNMA guaranteed roughly \$2.9 trillion in mortgage-backed securities (MBS).
- During fiscal year 2008, GNMA guaranteed 96.9 percent of eligible FHA-insured single-family mortgages.

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## Emergency Home Finance Act of 1970

- Created the Federal Home Loan Mortgage Corporation (Freddie Mac) to provide a secondary market for conventional and privately insured mortgages in order to increase the supply of money available for mortgage lending on home purchases and refinancings.
- Authorized Freddie Mac to purchase, hold, and sell such mortgages to investors on the open market. In other words, Fannie Mae was set up to operate as a portfolio lender — just like a savings and loan.
- Freddie's initial purpose was to help free the secondary market from its dependence on FHA's decreasing primary market activity and to help alleviate a critical shortage of housing at that time.

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## Operation of Freddie Mac

- In 1971, Freddie Mac began issuing a mortgage-backed security collateralized by conventional and privately-insured mortgages.
- These securities (called "participation certificates") were direct "pass-throughs" of principal and interest that were classified as investments in mortgages for tax purposes, but, because of the agency guarantee, represented little risk to the investor. However, like standard mortgages, they included monthly payments and uncertain life spans.
- In 1973, Freddie Mac developed and initially issued "Guaranteed Mortgage Certificates" — securities that were backed by conventional mortgages but included semi-annual interest payments (just like bonds), annual principal payments, and a guarantee by the Agency to repurchase the certificate at 100 percent of its outstanding balance on its 15<sup>th</sup> anniversary.

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## Operation of Fannie Mae

- Fannie Mae functioned strictly as a portfolio lender during the 1970s.
- Fannie Mae waited until 1981 to issue its first mortgage-backed security.

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## Regulation Prior to President Reagan

- Regulation reached its peak in the U.S. under the Nixon administration.
- Jimmy Carter initiated a small amount of de-regulation (e.g., in the airline, bus, and trucking industries) to try to “improve” the economy that had been buffeted by OPEC’s increased oil prices.

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## Reagan's Old-Time Economic Religion

- “We’re not going back to high-button shoes and celluloid collars. But the President does want to go back to many of the financial methods and economic incentives that brought about the prosperity of the Coolidge period.”

– Reagan’s Secretary of the Treasury, Donald Regan, former Chairman of the Board of Merrill Lynch:

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## Politics/Economics of De-regulation

- The Reagan administration believed that the economic ills of the 1970s — the decline of manufacturing and the twin evils of high unemployment and galloping inflation — were the result of excessive regulation of business, out-of-control public spending, and a tax system that was choking our entrepreneurial spirit.
- So, the Reagan administration was philosophically on the same wave-length as those advocating supply-side economics, who believed (1) as did Calvin Coolidge that “the chief business of the American people is business,” and (2) that the way to carry out that business was to dramatically reduce the portion of the federal budget going to domestic purposes.

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## Early Reagan Fiscal Policy

- In 1981, Reagan was able to effect a large reduction in the marginal tax rate charged those at the top of the income distribution.
- This caused some concern among Reagan's economic advisors about the Federal budget deficit.
- One result of this was an increase in payroll tax rates although the Reagan administration would have preferred to reduce Social Security program benefits instead.
- A second result was the return in 1982 of the VA funding fee of one half of one percent of the face amount of the mortgage.

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## Reagan's Commission on Housing

- President Reagan established this Commission because of
  - his concern “that continuation of past policies would deny future generations their ‘opportunity to live in decent, affordable housing’” and
  - his desire “to help chart a new path for the rest of the century.”

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## Commission Recommendations Concerning FHA

- “Like so much else that is 50 years old, FHA has become a prisoner of its own habits, and the Commission recommends that **more agile** private mortgage insurance institutions take over many FHA functions relating to single-family homes.”

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## Other Commission Recommendations

- The current crisis in housing is primarily a crisis in the financing of housing. A broader-based and more resilient system will be needed to supply the funds a strengthened housing industry will require.
- Looking toward the development of the new system, the Commission proposes an integrated package of recommendations designed to reduce the nation’s reliance on specialized lenders and a single type of mortgage instrument.
- In the future, housing will draw more funds from a wide range of private institutions including pension funds, insurance companies and commercial banks.
- To encourage greater participation in housing finance by such institutions, **the Commission recommends the removal of various tax, legal and regulatory impediments** to widespread private investment in mortgages and mortgage-backed securities.

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## Establishment of MGIC

- MGIC, the first private mortgage-guarantee insurance company since the Great Depression, was started in 1957 by Max Karl, a one-time real estate lawyer.
- MGIC was headquartered in Milwaukee and so was under the purview of the Wisconsin Insurance Department.

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## MGIC was started for two reasons.

- First, Mr. Karl felt that MGIC could expedite the process of closing the loans because he would not be constrained by federal red tape.
- Second, the interest rate ceiling on FHA- and VA-insured mortgages, that was meant to protect home buyers from usurious lending, had in practice made it impossible for some homebuyers to obtain financing unless the seller agreed to pay several “points” to compensate the lender for providing a mortgage with a below market interest rate.

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## MGIC's Business Plan

- Karl believed that a private company that insured only the top portion — 25 to 30 percent after the homebuyer's 5 percent down payment — presented lenders with a cheaper and more efficient means of financing the home purchase of borrowers unable or unwilling to make a down payment of at least 20 percent of the cost of acquiring a new home.

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## Profits Increase at MGIC

- From 1967 to 1973 [MGIC's] profits more than quadrupled every year.
- This explosive growth was, in part, the result of changes in federal regulations:
  - In 1971 regulatory authorities" reduced down-payment requirements, allowing "savings and loan associations to make mortgages up to 95 percent of appraised value (compared to 90 percent before) as long as loans were insured."
- Maximum mortgage amounts were also increased.
- MGIC more than doubled the dollar amount of its home loan insurance from \$2.8 billion in 1971 to \$7.5 billion in 1972, thereby surpassing FHA; about 40 percent of this increase occurred in the 95 percent loan category.

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## Karl's Philosophy Circa 1973 as quoted in the *Wall Street Journal*

- "I've always felt the proper role for the government was helping lower income groups acquire housing which would be unsound for us to insure anyway. ... Most of the business, it seems to me, would be better served by private companies."

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## MGIC and its Competitors

- With growth came competition. In 1973, MGIC had 10 private-sector competitors, although MGIC dwarfed its competitors.
- Of approximately \$11 billion in private residential mortgage insurance written in 1972, MGIC wrote \$7.5 billion, and the number of claims it had to pay annually — foreclosure on losses — remained a negligible \$2 million or less annually.
- Then suddenly in 1974, problems began to surface.

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## Financial Problems at MGIC in the 1970s

- First, its mobile home mortgage and commercial property mortgage ventures began to sour.
- Then, MGIC found itself borrowing short-term to finance its secondary mortgage market inventory.
- After a \$1.9 million net loss in 1974, MGIC stopped writing insurance on mobile homes and closed down its secondary market operation.

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## PMIs Return to Prosperity

- After the 1973-1975 recession, the private mortgage insurance industry continued to grow and prosper.
- The amount of insurance claims paid continued to be negligible and so it should not be surprising that during this period some of the PMIs viewed themselves more as providers of a service than as insurance underwriters or risk managers.
- Moreover, all charged insurance premiums that were roughly equal to those of MGIC, the industry leader.
- By 1977 private mortgage insurers were responsible for 12 percent of all new mortgages — up from 3.7 percent in 1970 — and were writing some \$21 billion in annual new coverage.

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## MGIC and MBS

- Mortgage-backed pass-throughs or certificates — a security built on pools of mortgages with monthly payments passed on to investors — were gaining ground in the industry, and Bank of America turned to MGIC for insurance when it became the first private lender to package such a certificate.
- This move as well as MGIC's longstanding position at the head of its industry attracted much positive attention to the company and made it ripe for a takeover.

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## Adjustable Rate Mortgages (ARMs)

- In 1981, the FHLBB permitted federally chartered, member thrifts, by regulation, to offer alternative, variable-rate mortgage instruments.
- Then the next year, according to Garcia et al of the Federal Reserve Bank of Chicago [1983], the Garn-St. Germain Depository Institutions Act of 1982, empowered “state banks and thrifts ... to offer the alternative, variable-rate mortgage instruments that are permitted to their federal counterparts.”

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## Creation of Option ARMs

- Option ARMs were created in 1981 by Herb and Marion Sandler who owned Golden West Financial Corp. and its subsidiary World Savings Bank.
- In particular, the Sandlers are credited with the invention of the “Pick-A-Pay” mortgage that allowed borrowers to pay less than the interest due on their loan each month.

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## Option ARMs in Practice

- For many years, option ARMs were marketed to well-heeled buyers who wanted the option of making low payments most months and then paying off a big chunk all at once.
- For these borrowers, option ARMs offered flexibility.
- For the lender, affluent borrowers were not of great concern as they were unlikely to default on their mortgages.
- This was not the case for financially strapped borrowers during the housing bubble of 2004 to 2007. For such borrowers, option ARMs were lethal.

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## Financial Results for the PMI Industry during the 1980s

- Because some of the private mortgage insurers viewed themselves more as service providers than as risk managers, they began insuring riskier loans.
- During 1984, about 50 percent of PMI loans had loan-to-value ratios above 90 percent and roughly 60 percent of these were ARMs or other loans with negative amortization.
- Some PMIs had heavy concentrations of risk in overbuilt markets of states that (1) were energy-producers and/or (2) had problem S&Ls.
- Between 1985 and 1989, the industry had direct incurred losses in excess of \$5.7 billion.

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## PMI INDUSTRY -- COMBINED RATIOS

Year	Active Companies	Total Industry
1981	89.7%	75.1
1982	122.7	109.0
1983	118.9	116.4
1984	111.7	109.1
1985	145.2	151.1
1986	123.2	168.7
1987	140.3	220.7
1988	113.2	155.4
1989	88.2	130.5
1990	78.7	95.4
1991	69.3	80.2

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## Falling Fortunes of PMIs

- One consequence of this was that the number of private mortgage insurance companies actively writing new business dropped from 14 in 1980 to nine in 1994.
- Two of the private mortgage insurance companies ran into serious financial trouble: Ticor and MGIC.
- Two others — Verex, and Investors Mortgage Insurance Company (IMI) — ceased operating because their parent companies decided against putting in additional capital.

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## FHA

- During the 1980s, researchers at conservative policy institutes, such as the Heritage Foundation and the American Enterprise Institute, continued to propound the Reagan Administration's de-regulation policies in the mortgage finance field.
- They argued that the federal government's housing agencies should either have no future role or a vastly diminished one.

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## *“How Congress Can Defuse the Federal Housing Administration Time Bomb”*

- Moore [1986; page 5] argued that “the FHA has strayed far from its legislative mandate ... to provide mortgage protection to those of low and moderate income possibly underserved by the private mortgage industry.”
- He added that in 1986 “FHA seems intent on stifling the private mortgage insurance market.”

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## FHA during the 1980s

- Like other mortgage market participants, FHA incurred substantial insurance claims on the single-family mortgages it insured during the early 1980s. In part, this was simply due to the workings of the business cycle because FHA typically has fewer insurance claims in rising interest rate environments than in falling ones because of the assumability of its mortgages. In part, it was due to how the savings and loan crisis was handled by the Reagan administration. Specifically, easy lending standards increased demand for single-family homes and thereby pushed up their prices. Eventually, after the easy money dried up, the house prices had to fall. This created problems for many participants in the housing industry, including FHA.

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## Tightening FHA Underwriting

- During the second half of Reagan’s tenure, HUD Secretary Pierce established a task force whose mission was to tighten single-family underwriting standards in order to reduce credit risk.
- The result, according to Chappelle [1991], was that “FHA has tightened its underwriting policies since 1986 with over 30 different measures (e.g., buydown restrictions, elimination of risky programs and stricter compensating factors for borrowers above credit ratio guidelines) to reduce credit risk.”

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## MMI FUND CAPITAL RESOURCES FY 1988 through FY 1991

End of Fiscal Year Audit	Total Capital Resources (Dollars in Billions)
1988	8.35
1989	8.13
1990	8.48
1991	8.94

Source: FHA Audited Financial Statements for FY 1988-1991

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## FHA Under HUD Secretary Kemp

Nevertheless, despite

- (1) the sanguine financial statements and
- (2) the recently tightened underwriting standards,

the Kemp administration increased the insurance premiums charged on single-family, 30-year term mortgages insured under the MMI Fund by adding a one-half percent annual premium to the 3.8 percent upfront mortgage insurance premium on mortgages closed on or after July 1, 1991.

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## Consequences of Increasing FHA MIP

- As an immediate consequence, according to Chappelle [1991; page 96]: “Applications for FHA insurance ... dropped 28 percent from April to August 1991.”
- Chappelle went on to add that: “HUD has increased the likelihood of adverse selection in the FHA program. Because of the increased cost [of FHA mortgage insurance], lower-risk borrowers who are the backbone of the FHA program are now opting for private mortgage insurance because of lower cost and less red tape. FHA is, therefore, in effect becoming the lender of last resort.”

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## Risk to FHA

- The bad news for low- and moderate-income homebuyers was that they were being forced to pay higher mortgage insurance premiums to compensate for the mismanagement of the private mortgage insurance companies during the 1980s.
- Chappelle [1991; page 96] concluded his article by noting that based on the tightened underwriting described above, “it is ironic that it now appears that FHA faces greater risk to its future solvency from the implementation of measures designed in the spirit of reform than it does from the performance of its existing portfolio.”

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Distribution of Insured Single-family Mortgage Originations  
by Type of Insurance  
1982-1993

Year of Origination	FHA	VA	PMIs
1982	18.0%	15.7%	66.2%
1983	27.9	20.2	52.0
1984	15.2	14.1	79.6
1985	28.9	14.7	56.4
1986	47.2	19.1	33.8
1987	55.5	20.6	23.9
1988	47.4	16.9	35.7
1989	51.2	15.7	33.1
1990	52.8	15.8	31.4
1991	44.1	14.5	41.4
1992	33.4	16.1	50.5
1993	37.5	17.3	45.2

Sources: FHA, VA, MICA as reported in Canner and Passmore [1994].

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## First Private Issue of Mortgage-Backed Securities

- During 1977, Salomon Brothers “persuaded the Bank of America to sell them the home mortgages it had made — in the form of bonds.
- Salomon Brothers then persuaded investors, such as insurance companies, to buy the new bonds.
- When they did, the Bank of America received the cash it originally lent the homeowners, which it could then relend.
- The homeowner continued to write his mortgage payment checks to the Bank of America, but the money was passed on to the Salomon Brothers clients who had purchased the Bank of America bonds.
- Thus, the first private label (non-agency) mortgage-backed security was created.

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## Impediments to Non-agency MBS

- While Salomon Brothers was convinced that this approach was “the wave of the future,” it had a number of hurdles to overcome:
  - The SEC required reams of documentation for every mortgage pool and
  - The Internal Revenue Service wanted to tax such transactions.

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## Other Impediments to Non-agency MBS

- In addition, Salomon Brothers' approach was only legal in three of the 50 states.
- Specifically, most states had laws barring pension funds and other financial custodians from purchasing securities that had not been officially registered with state agencies and been sold by an approved GNMA issuer.
- Such laws were enacted to “prevent the sale of bogus securities” and to ensure that the issuer met minimum capital requirements.

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## Salomon Brothers: In Search of a Solution

- So, Salomon Brothers put together a team of lawyers and lobbyists in Washington, D.C. to get Congress to pass legislation to
  - (1) preempt the state laws and thereby “go over the heads of the states” and
  - (2) eliminate the potential difficulties posed by the SEC and the IRS.

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## The Road to Non-agency MBS

- During the Reagan administration, at least two new federal statutes and two regulatory changes facilitated the market in private-label mortgage-backed securities.
- The new statutes were the Secondary Mortgage Market Enhancement Act (SMMEA) of 1984 and the Tax Reform Act of 1986.
- The two regulatory changes were instituted in 1983 — one by the SEC and the other by the Federal Reserve Board.

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## Principle Provisions of Secondary Mortgage Market Enhancement Act

- It permitted “nationally recognized statistical rating organizations” (in 1984, Moody’s and Standard & Poor’s) to rate mortgage pools. Such pools could then be sold as mortgage-related securities if at least one of the rating organizations placed the pool in one of its two top rating categories.
- It permitted “federally chartered financial institutions, including credit unions, to invest in mortgage-related securities subject only to limitations that the appropriate regulating board might impose.”
- It preempted “state blue sky and legal investment laws and regulations so that investment grade mortgage-related securities may be purchased by state-chartered and regulated financial institutions, insurance companies, pension funds, trustees, or other regulated entities. However, the legislation gave the individual states up to seven years (until Oct. 3, 1991) to override this provision. Twenty-one states chose to do so.
- It exempted MBS from the state laws requiring that they be registered with the individual states.

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## Tax and Regulatory Change

- Meanwhile, the 1986 Tax Reform Act eliminated the issues with the IRS.
- Prior to 1983, brokerage firms and dealers could accept agency pass-throughs, but not private pass-throughs, from their customers as collateral for margin transactions. The Federal Reserve Board changed that during January 1983 when it rewrote Regulation T to treat private pass-throughs in the same fashion as agency pass-throughs.

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## A Lone Skeptic

- According to Katz [2009; page 19], at a 1984 Congressional hearing, Democratic “Representative Tim Wirth [of Colorado] voiced a lone and passionate cry of skepticism. Why set up private investment banks to do the same thing that [Ginnie, Fannie, and Freddie] already could legally accomplish. And why trust the inscrutable, unaccountable rating agencies, which had already shown a tendency to give high scores to failing bonds?”

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## Private Label (non-agency) Residential Mortgage-Backed Securities

- The actions described above enabled private firms — commercial banks, investment banks, or other mortgage originators — to pool residential mortgages and sell them as pass-throughs without any government guarantees.

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## Non-agency Residential Mortgage-Backed Securities Originations

Year	Dollar Amount of Non-agency Residential Mortgage-Backed Securities Originated (in billions of dollars)	Percent of Total Residential Mortgage-Backed Securities Originated
1998	203.2	21.9%
1999	147.9	17.8
2000	136.0	22.1
2001	267.3	19.7
2002	414.0	22.3
2003	586.2	21.6
2004	864.2	45.9
2005	1,191.3	55.3
2006	1,142.4	55.7
2007	707.0	37.9
2008	51.8	4.2

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## U.S. Banks versus Foreign Banks

- According to Gruver [2008], by 1999, the idea that an individual U.S. financial institution should be prohibited from both selling risky investment products and accepting deposits from the public had become an anachronism of the New Deal.
- Foreign banks like UBS and Deutsche Bank engaged in both (1) the underwriting of securities and (2) lending and deposit-taking, which put American banks at a competitive disadvantage in the global marketplace.
- 1998 Merger of Citicorp and Travelers (CitiGroup)

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## Gramm-Leach-Bliley Financial Services Modernization Act

- Repealed the sections of the 1933 Glass-Steagall Act mandating the legal separation of (i.e., the firewalls between) commercial banking and investment banking.
- Eliminated the Bank Holding Company Act of 1956's prohibition on bank underwriting of insurance (helping CitiGroup).
- Established the Federal Reserve Board as the primary regulator of financial holding companies.
- Permitted financial holding companies to conduct activities that are "complementary" to banking.
- Grandfathered for 10 years the nonfinancial activities of firms engaged in financial business.

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## Commodity Futures Modernization Act of 2000

- Because of the default swap-related provisions of this bill, a market that ultimately reached about \$62 trillion remained utterly unregulated, meaning no one made sure the banks and hedge funds had the assets to cover the potential losses they guaranteed.

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## PMI INDUSTRY -- COMBINED RATIO

Calendar Year	Combined Ratio
1996	70.8%
1997	63.4%
1998	58.0%
1999	45.4%
2000	35.7%
2001	40.7%
2002	45.4%
2003	48.3%
2004	62.5%
2005	60.4%
2006	65.0%
2007	154.0%

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## FHA Single-family Activity through June 30, 2009

Fiscal Year	FHA Share of Home Purchase Activity
1998	7.12
1999	7.96
2000	7.71
2001	7.87
2002	6.93
2003	5.09
2004	3.28
2005	1.89
2006	1.75
2007	2.04
2008	8.14
2009 (Thru June 30, 2009)	13.94

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THANK YOU!!

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