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and Techniques
in Today’s
Financial
Environment”

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The Impact of the 2007 Mortgage Crisis on Today’s Mortgage Loan Shopper

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The Evolution of the US Mortgage Industry and the Impact of the Crisis on Today's Borrower

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PRESIDENT AND CEO

Agenda

- **The Beginning (1937- mid 1980's)– Early period of the Housing Industry**
 - The early period of the housing industry was marked by the federal government's programs to stimulate homeownership
- **The End of the Beginning (mid 1980's – late 1990's) – Period of changes that would have lasting effects**
 - Business changes
 - Political changes
 - Structural changes
 - Wall Street's changes

Agenda

- The Beginning of the End (late 1990's – 2006) – **The period where “success bred excess”**
 - The recipe for disaster
- The End (2007-2008)
 - The perfect storm
 - The bail-out of Wall Street
 - The fall-out to Main Street

The Beginning

- FDR's New Deal
 - Fundamental shift in the government's role
 - ✦ Social Security program
 - ✦ Government protection of deposits (FDIC, FSLIC, ect)
 - ✦ Separated commercial banking activity and investment banking activity. (Banking Act of 1933 aka Glass Steagall Act)
 - ✦ Creation of the Government Sponsored Enterprises (GSEs) – Freddie Mac and Fannie Mae

The Beginning

- **GSEs.** Enterprise established to enhance the flow of credit to a specific target.
 - Farm Credit System. 1916
 - Fannie Mae was created in 1938

The Beginning

- **Freddie Mac and Fannie Mae (aka GSEs)**
 - Provide liquidity to the housing market through
 - ✦ Mortgage purchases
 - Direct whole loan purchases from lenders
 - Lender loan pools
 - ✦ Loan guarantees
- Initially, GSEs would take the mortgages from the lenders, pool them and then issue Participation Certificates.

The Beginning

Participation Certificate - A type of security that groups together GSE conventional mortgages. These certificates are guaranteed by GSE and are taxable by federal, state and the local government.

These certificates are also referred to as "pass-through" because the interest and principal payments are periodically passed through to investors from debtors after service fee deductions.

The Beginning

- **Securitization-** The financial practice of pooling various types of contractual debt such as residential mortgages, commercial mortgages, auto loans or credit card debt obligations and selling said consolidated debt as bonds to various investors.
- **Mortgage Backed Securities (MBS)-** Bonds secured by the underlying mortgages in the pool.

The Beginning

The securitization process that started in the 70's had the advantage of providing capital at a time when demand for housing from the baby boomers coming of age made funding scarce and inflation made traditional forms of financing expensive.

The Beginning

- Buyers of these MBS are:
 - Insurance companies
 - Pension funds
 - Banks and other financial institutions
 - Individuals through mutual fund vehicles
- When buyers invest in these securities, they provide cash/capital to the GSEs, who repeat the process.

Step 1

- Lender originates a real estate loan

Step 2

- Lender sells the loan to GSE
 - With the money, the lender is able to make more loans
- GSE takes the loan and bundles them with other loans of similar characteristics

Step 3

- GSE wraps the loans into a pool.
- They securitize it and put a limited guarantee on it as to principal.
- Rating agency puts a rating on it

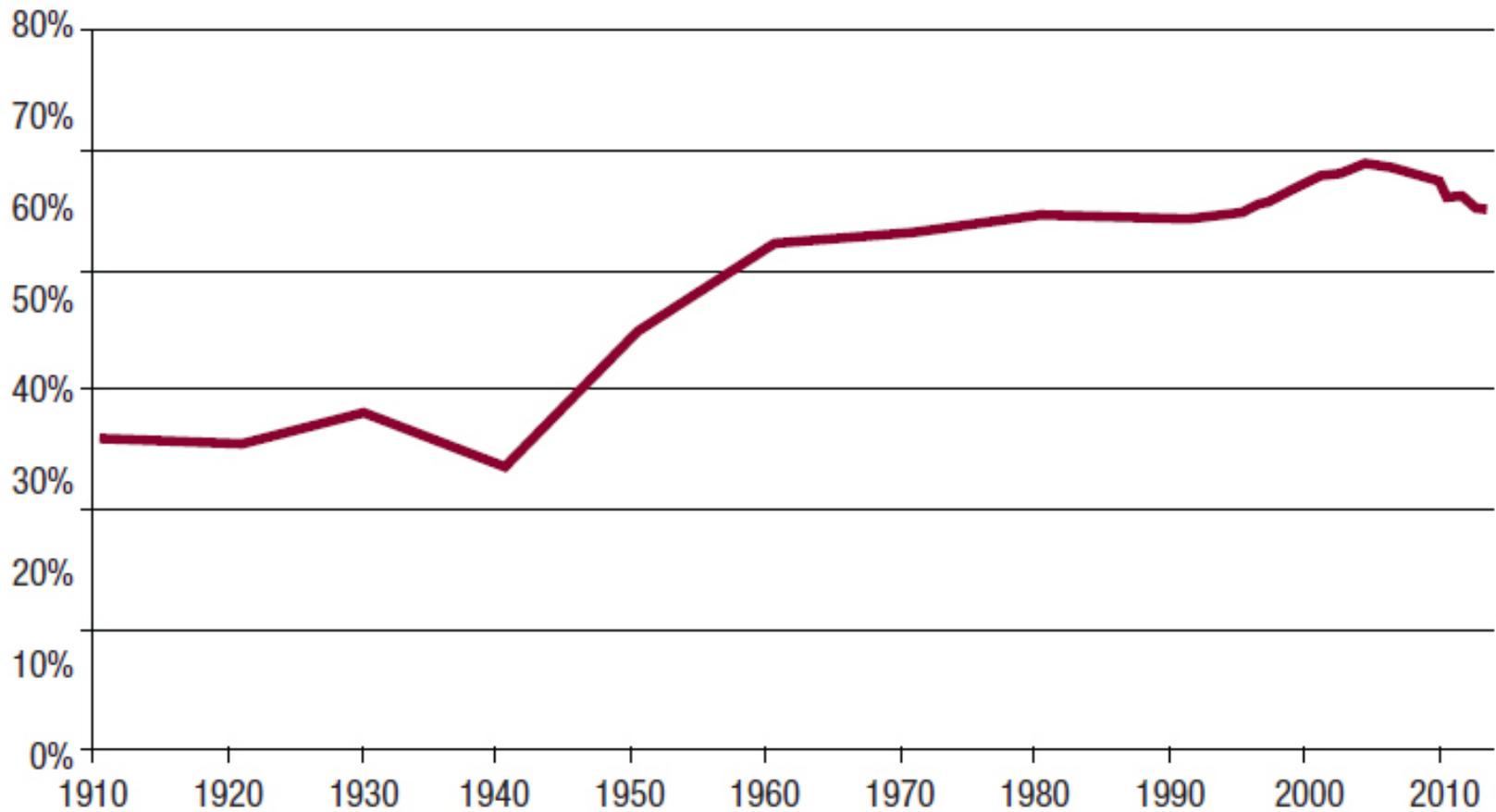
Step 4

- It is now a Mortgage Backed Security
- MBS is sold to investors

Step 5

- Proceeds of the sale are used by GSEs to repeat the process

Chart 1 **Long-Term U.S. Home-ownership Rate, 1910-2013**



Source: United States Census Bureau



The End of the Beginning

- Up through the 60's housing market is growing rapidly.
- Beginning in the 60's, growth levels off
- In general,
 - Growth is steady with normal periods of corrections that are mild and short term
 - Consumers have reasonable expectations of the market
 - Consumer's equity continues to grow

The End of the Beginning

So, what happened??

There isn't any one thing that we can point to that represented the main cause of the crisis. Rather, it was a number of political decisions coupled with changes in thinking about risk and timing that all combined to create the perfect storm.

The End of the Beginning

- Beginning in the mid 90's there were a series of seemingly small changes to government programs and the regulatory mindset
- The financial entrepreneurs created product at a pace too quick for regulators and rating agencies to fully understand
- New players entered the industry. They were unregulated.

The End of the Beginning

1. **Business changes.** The role of private capital in the mortgage business grew as private industry saw opportunity

- Similarities

- ✦ They act like a GSE by providing capital to financial institutions

- Differences

- ✦ No government guarantee to the investor
- ✦ Pricing difference
- ✦ Underwriting is more flexible

The End of the Beginning

- Differences (continued)
 - ✦ Private investing market determines whether this vehicle is successful
- Major difference...
 - ✦ Private mortgage market has no obligation to the housing market.
 - ✦ GSEs must be their in good and bad markets.

The End of the Beginning

- Some private mortgage label lenders
 - Countrywide
 - Washington Mutual Bank
 - Wells Fargo
 - Bank of America
 - Independent National Mortgage Corp
 - Wachovia
 - GreenPoint Mortgage

The End of the Beginning

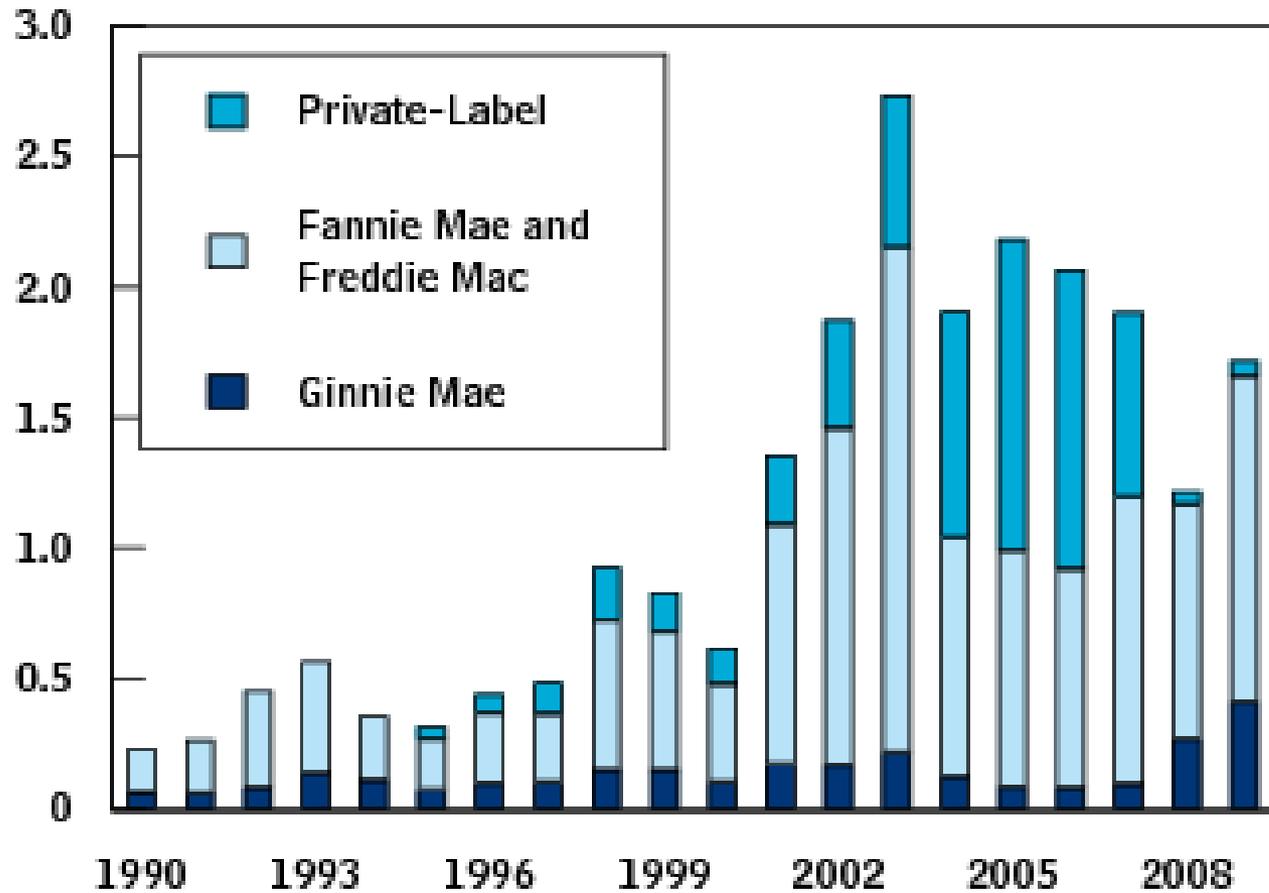
- MBS Underwriters
 - Merrill Lynch
 - Bear Stearns
 - Goldman Sachs

The End of the Beginning

- First private label MBS was issued by Bank of America in 1977
- First GSE created MBS issued in 1981 by Fannie Mae. Prior to that, GSEs issued Participation Certificates

The End of the Beginning

The growth in the securitization volume



The End of the Beginning

2. **Political Changes.** Political objective – Equate homeownership with the American Dream

- Deregulation of the banking system. The blurring of the lines between what a commercial and investment bank could do created inherent conflicts of interest
- Changes to what the GSEs could and how much risk they could assume.

The End of the Beginning

3. **Structural Changes.** Traditional lending conditions that helped to reduce the potential of a bubble

- Borrowers required to come up with 20%.
 - ✦ **125% LTVs, no down payment loans, no doc loans**
- Lenders used traditional underwriting methods to verify credit worthiness
 - ✦ **Automated underwriting and abbreviated underwriting**

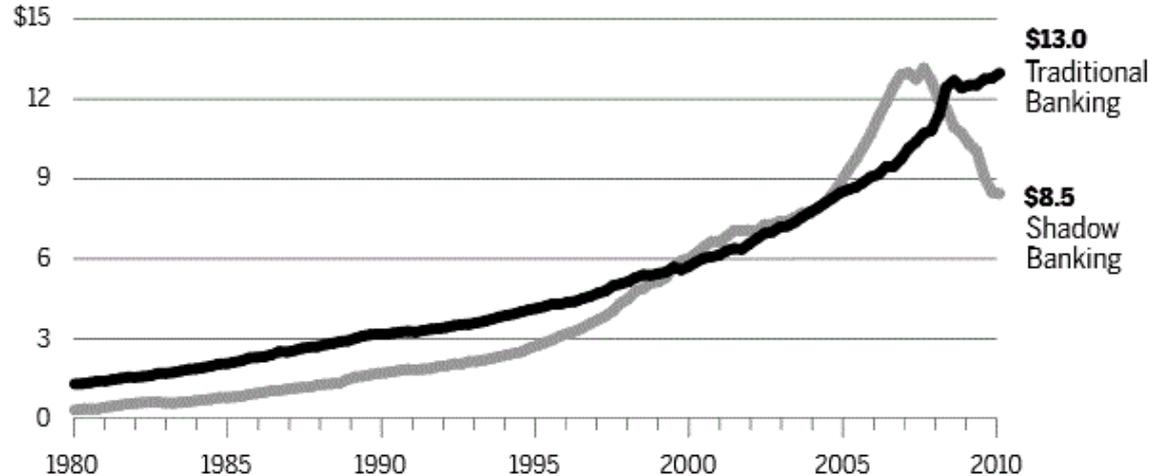
The End of the Beginning

- Primary source of loan origination was an officer of a financial institution
 - ✦ **Other non bank lenders and brokers**

Traditional and Shadow Banking Systems

The funding available through the shadow banking system grew sharply in the 2000s, exceeding the traditional banking system in the years before the crisis.

IN TRILLIONS OF DOLLARS



NOTE: Shadow banking funding includes commercial paper and other short-term borrowing (bankers acceptances), repo, net securities loaned, liabilities of asset-backed securities issuers, and money market mutual fund assets.

SOURCE: Federal Reserve Flow of Funds Report

The End of the Beginning

- Aggressive government monitoring and regulation kept greed in check
 - ✦ **This changed with deregulation of the banking system**

The End of the Beginning

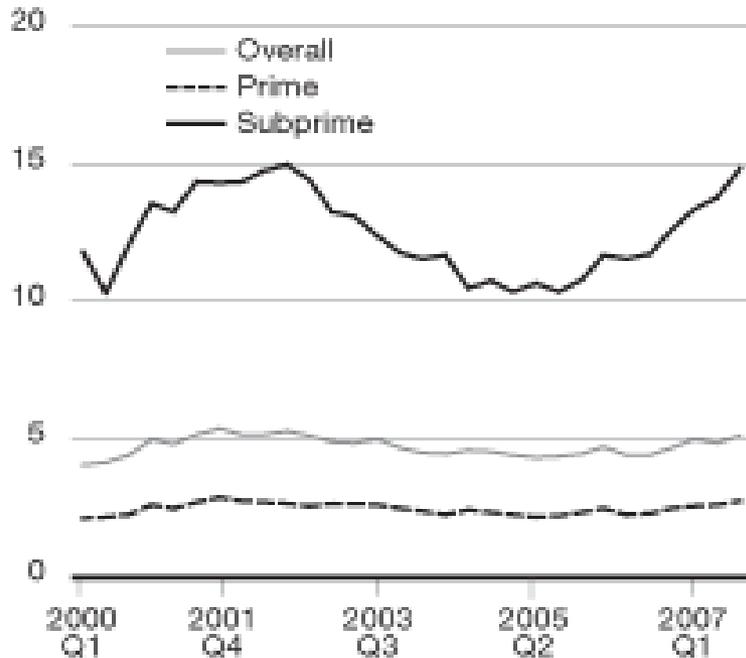
4. Wall Street changes. The financial entrepreneurs

- Since historically, losses were low, investors became willing to take on more risk.
 - ✦ Created new product (Interest only loans, 125% LTVs)
 - ✦ Willing to lend to riskier borrowers
- New structures
 - ✦ Asset Backed Securities (ABS). This complex bond structure had multiple types of loan pools of varying risk

Chart 1.3

U.S. Mortgage Delinquency Rates

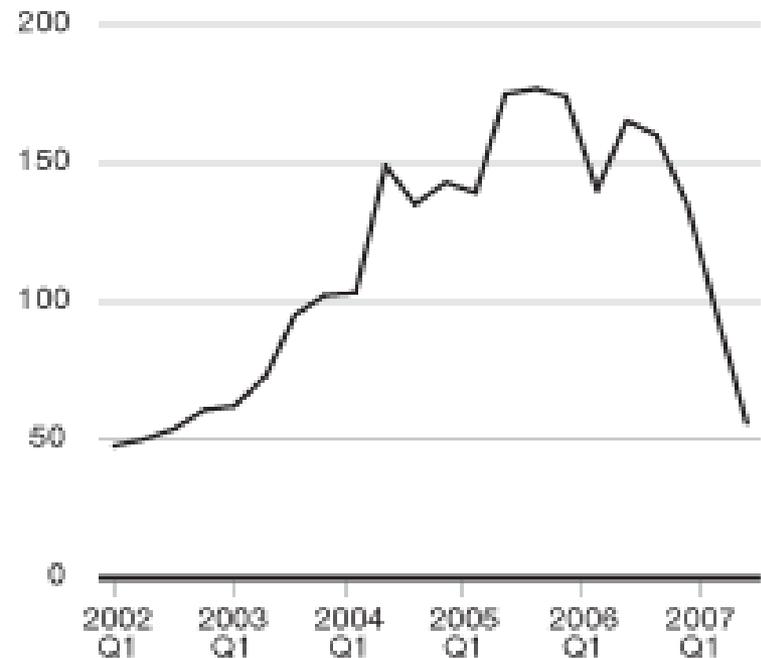
per cent



Source: Mortgage Bankers Association.

U.S. Subprime Mortgage Originations

US\$ billions



Source: *Inside Mortgage Finance*.

The low delinquency rate of the early 2000's gave financial entrepreneurs a false confidence that it would continue

The End of the Beginning

- **New players**

- Mortgage Brokers. Originated loans for lenders
- Mortgage Bankers. In business to originate and service mortgage loans
- Specialty mortgage companies
 - ✦ Sub-prime Mortgages
 - ✦ Jumbo loans

The End of the Beginning

- Review:
 - Mortgage industry booming caused primarily by a surge in demand caused by baby boomers
 - Politics included homeownership as part of the “American Dream” and created policy to grow capacity
 - Private label mortgages were born and helped to fuel the boom

Intermission

10 MINUTE BREAK

The Beginning of the End

- Early 2000's the US was in the midst of a recession.
- Several companies were caught up in fraud causing their demise
 - WorldCom, Global Crossing and Enron, Arthur Anderson are among the most notable companies that caught up in the accounting scandals

The Beginning of the End

- 9/11 also had the effect of curtailing economic activity.
- So, to jump start the economy, the FED assured liquidity in the system by dropping interest rates.
 - This had the effect of fueling the housing market beyond anyone's expectation.
- More Private Labeled Mortgages were being issued to address demand

The Beginning of the End

As private label mortgages continued to displace the GSEs in terms of securitization volume, Congress started to question the relevance of the GSEs.

- Deregulation seemed successful as private industry provided sufficient capacity
- Some in Congress were concerned about the cost to the tax payer of rescuing Freddie or Fannie, although at the time, the thought of this was more hypothetical than probable

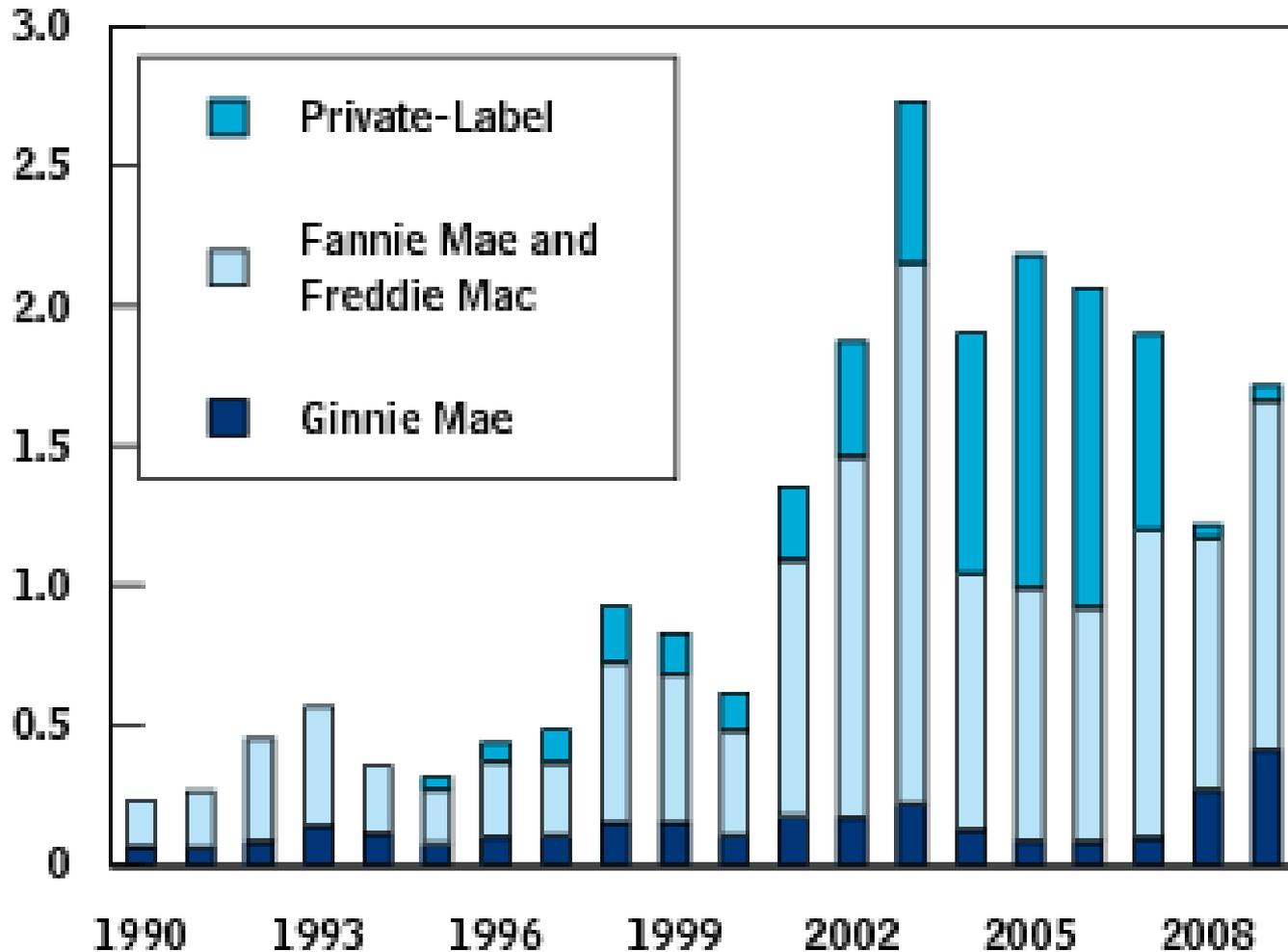
The Beginning of the End

- Still others thought that the GSEs weren't able to compete fairly with the private labels given the higher regulatory burden placed on the GSEs

So, Congress picking up on the perceived success of financial de-regulation, continued to release more of the restrictions that governed the GSEs

The Beginning of the End

The growth in the securitization volume



The Beginning of the End

A Recipe for Disaster ...

- New Players - unregulated and unmonitored
- Financial Entrepreneurs – creating new product with little thought to risk and motivated by huge bonuses
- A friendly government - caught up in the momentum and current success of de-regulation
- Investors chasing yield in a low rate environment

The Beginning of the End

- **Economic landscape made these factors LETHAL**
 - **Low interest rate environment.**
 - ✦ Fueled a massive refinance boom
 - ✦ Made investors seek higher returns by agreeing to take on higher risk
 - ✦ Fueled a massive housing boom
 - **Politicians looked to the Housing Market to jump start the early 2000 slow down**

The Beginning of the End

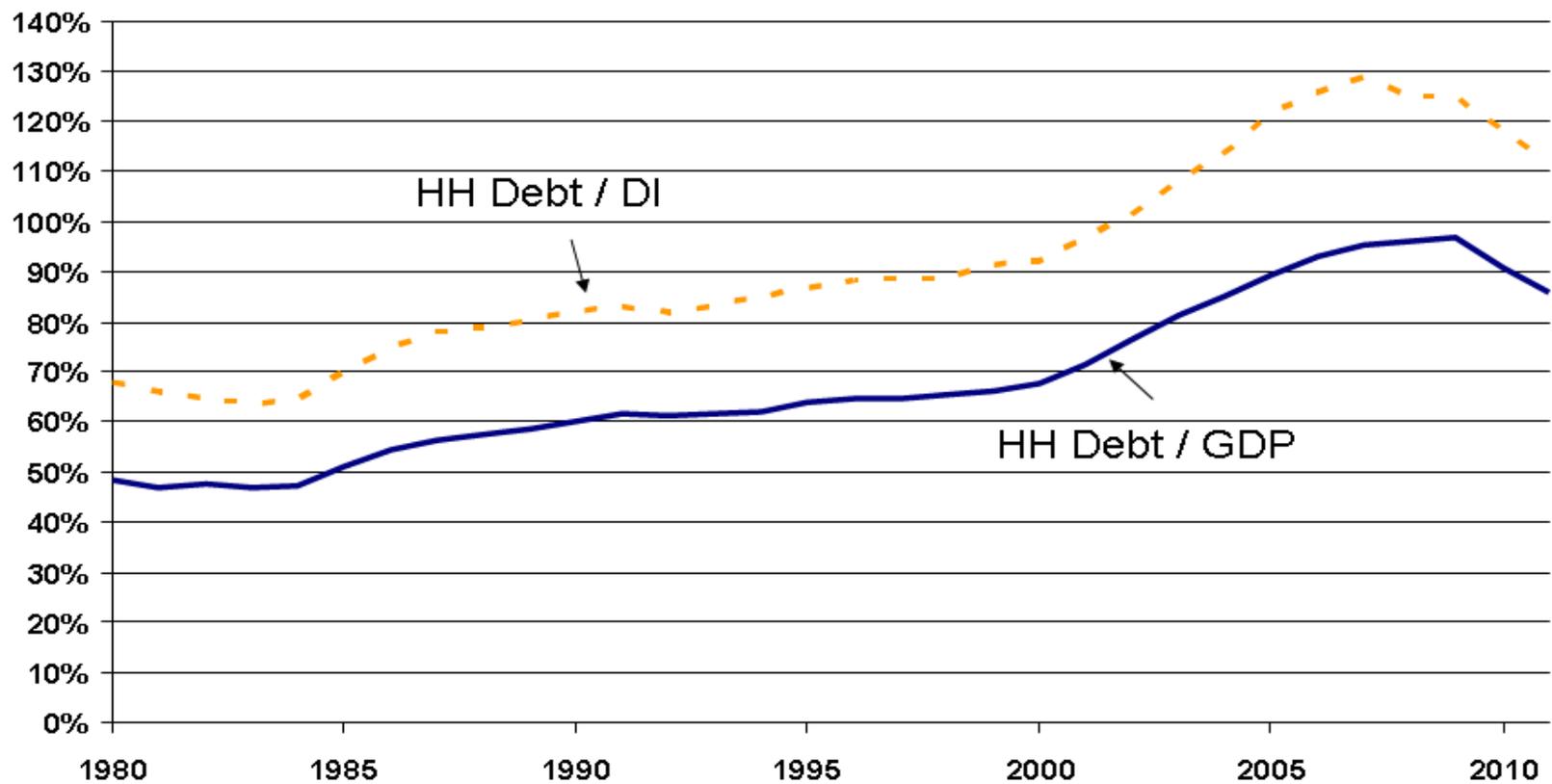
And the force that pulled these ingredients together ...

The Beginning of the End

The US Consumer

caught up in the low rate refinance boom and the quick profit of the booming purchase market

U.S. Household Debt vs. Disposable Income (DI) and GDP



Sources: U.S. Federal Reserve (FRED), BEA
Note: HH Debt is FRED "CMDEBT" variable



The Beginning of the End

What you have in Economist's terms is *Disequilibrium* *defined*: loss or lack of equilibrium or stability, especially in relation to supply, demand, and prices.

cause: A limited but growing supply of mortgage product and strong demand chasing the limited supply

The Beginning of the End

Typically, this situation results in a correction...

Either

1. Prices increase beyond consumer's affordability ...
demand declines to meet supply
2. Supply increases to meet current demand

The Beginning of the End

In this case, the underlying fundamentals were unsustainable and so what would otherwise be a normal housing correction became much worse.

- The next few slides include graphical representations of what was happening in the housing industry through the peak in the mid 2000's

Rate of Increase in House Prices 1978:Q1-2009:Q3



Note: Shaded areas refer to NBER recessions.
Source: FirstAmerican LoanPerformance.



Date Selection

Members Only. Please [Sign Up](#)

January

2001

to

January

2009

EXPORT DATA

COMPARE

SHOW FORECAST

UNITED STATES INTEREST RATE

Benchmark Interest Rate



source: TradingEconomics.com; Federal Reserve

Between 9/11/2001 through mid 2005, interest rates remained low. The gradual increase through 2007 made the mortgage resets unaffordable for the subprime borrowers.

Growing apace

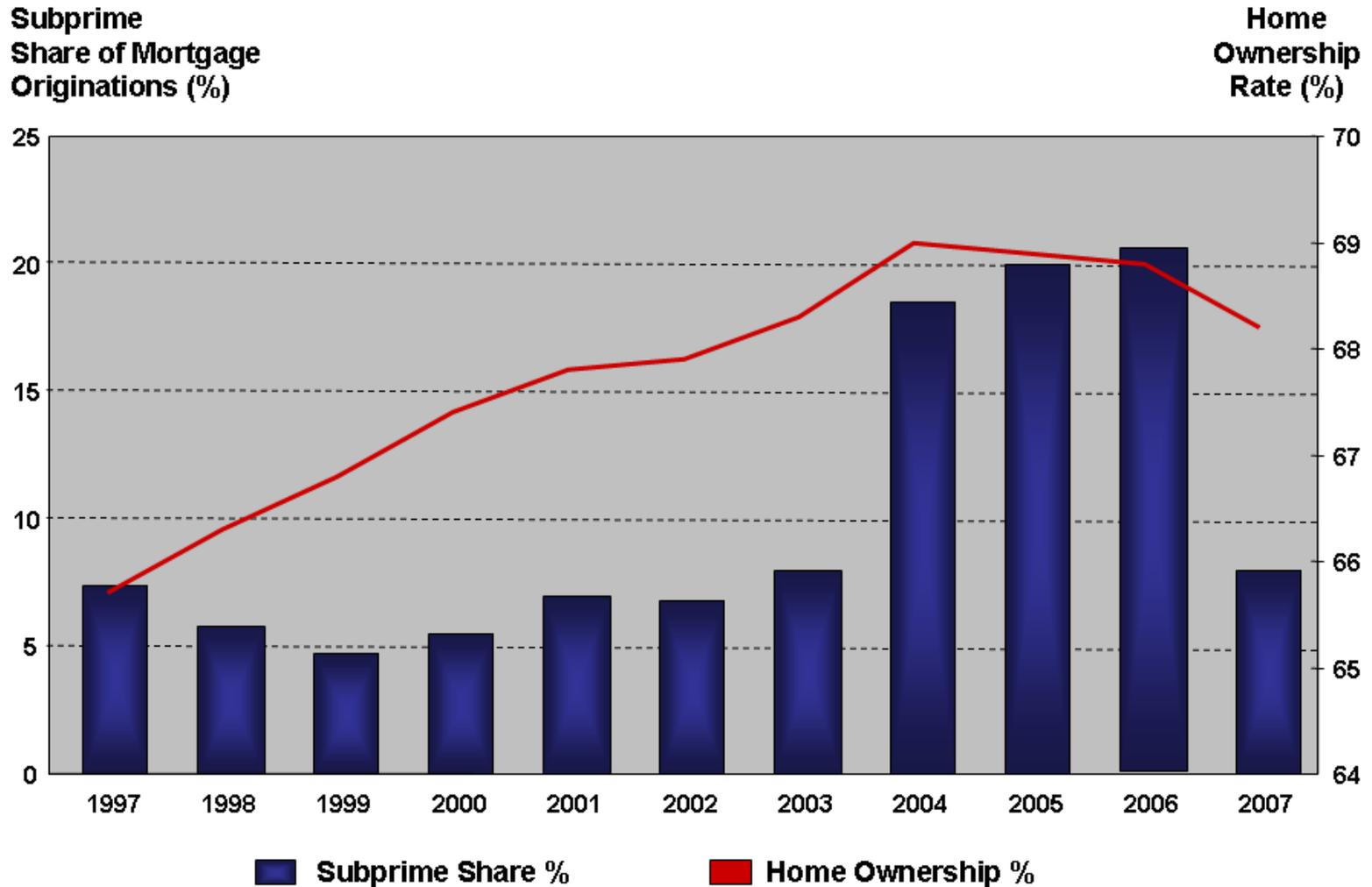
Issuances of below-investment-grade mortgage-backed securities ballooned between 2003 and 2006.

(billion dollars; percent of total)

Type	2003	Jan.–June 2006
Prime	57.6 (52)	67.2 (26)
Subprime	37.4 (34)	114.3 (44)
Alt-A	15.8 (14)	76.5 (30)
Total	110.8	258.0

Source: *Inside Mortgage Finance*.

U.S. Subprime Lending Expanded Significantly 2004-2006

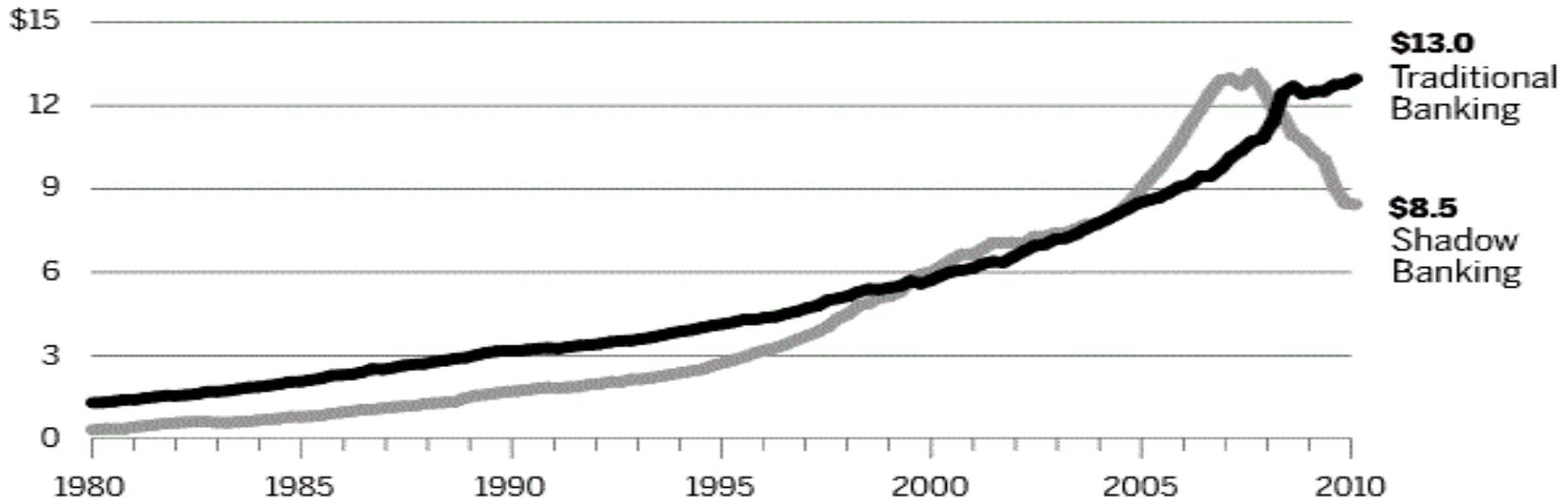


Sources: U.S. Census Bureau; Harvard University- State of the Nation's Housing Report 2008

Traditional and Shadow Banking Systems

The funding available through the shadow banking system grew sharply in the 2000s, exceeding the traditional banking system in the years before the crisis.

IN TRILLIONS OF DOLLARS



NOTE: Shadow banking funding includes commercial paper and other short-term borrowing (bankers acceptances), repo, net securities loaned, liabilities of asset-backed securities issuers, and money market mutual fund assets.

SOURCE: Federal Reserve Flow of Funds Report

Financing being performed by new entrants.

The End

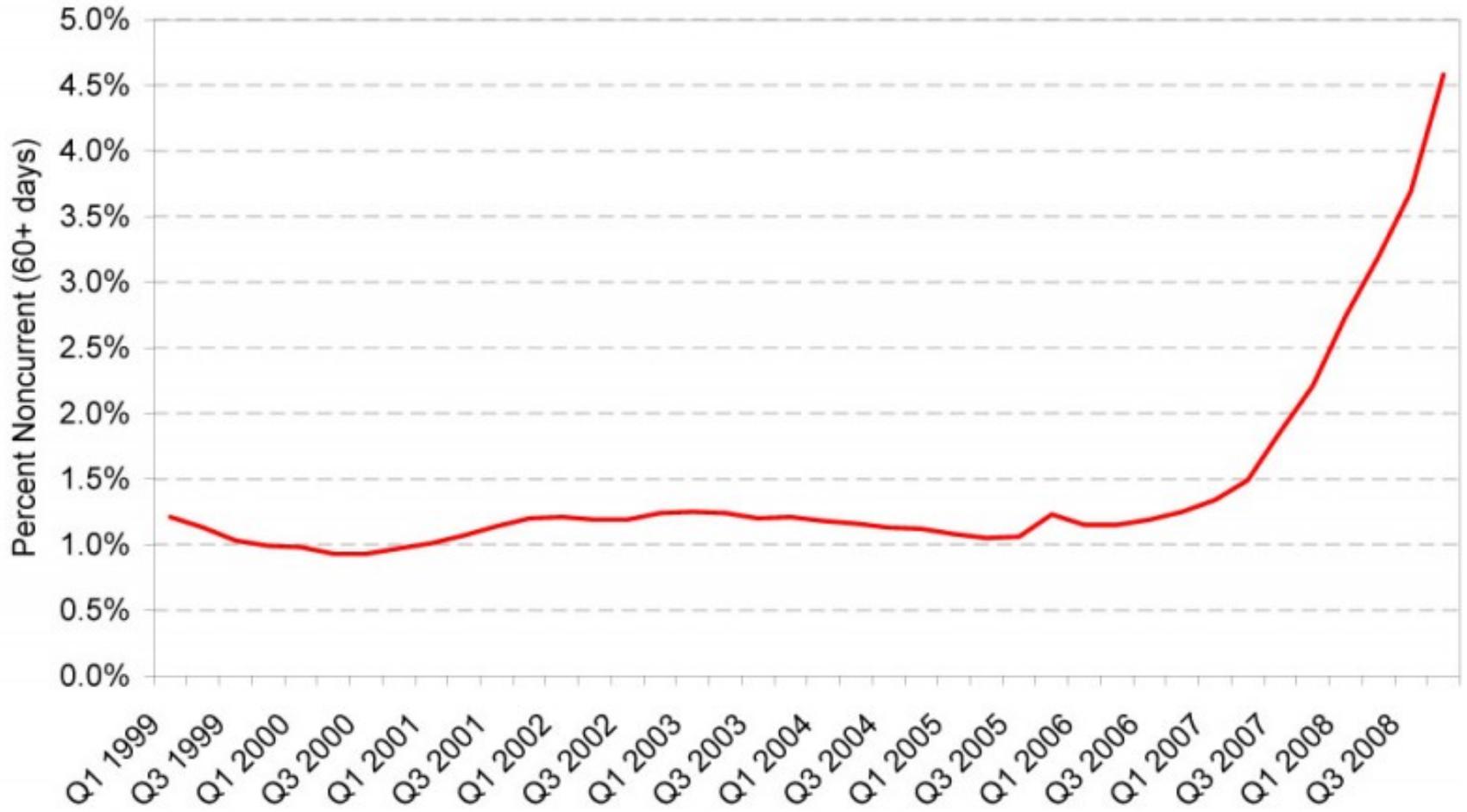
- Housing trends between 2000-2006
 - Housing prices increasing
 - A low interest rate environment making consumers buying power higher
 - The growth financed by sub-prime mortgages
 - Non traditional lenders leading the origination boom (no skin in the game)

The End

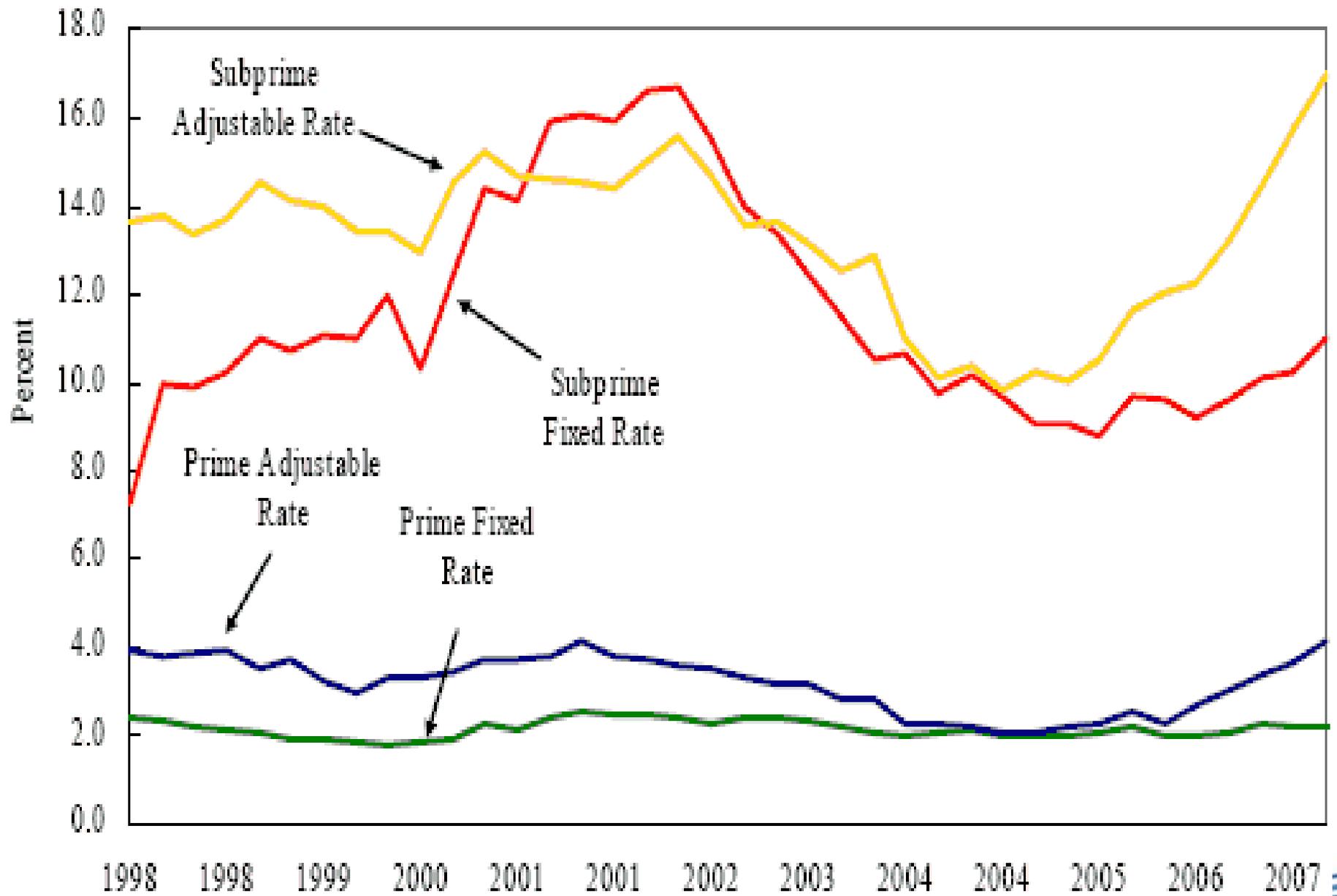
Beginning signs of the End ...

- The end of 2006 many on Wall Street were talking about how valuations in the MBS market no longer made sense
- Many of underlying assets of the MBS were showing stress as the loans were re-pricing and borrowers were unable to afford the new payments

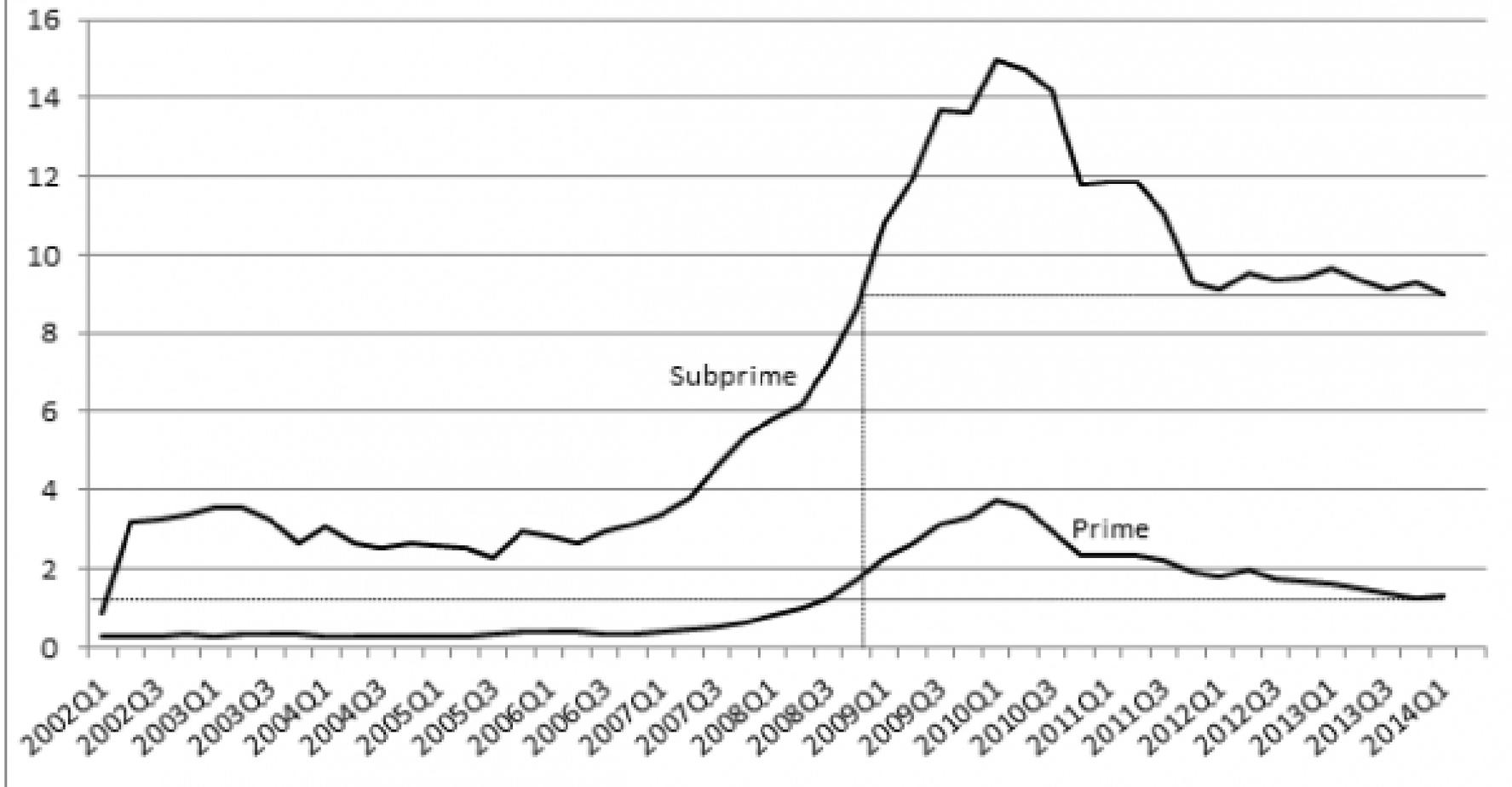
Figure 4.4 Prime Mortgage Delinquency Rate



SOURCE: National Delinquency Survey, Mortgage Bankers Association. Note: Seasonally adjusted.



Percent of loans 90+ days delinquent: Prime vs. subprime mortgage loans

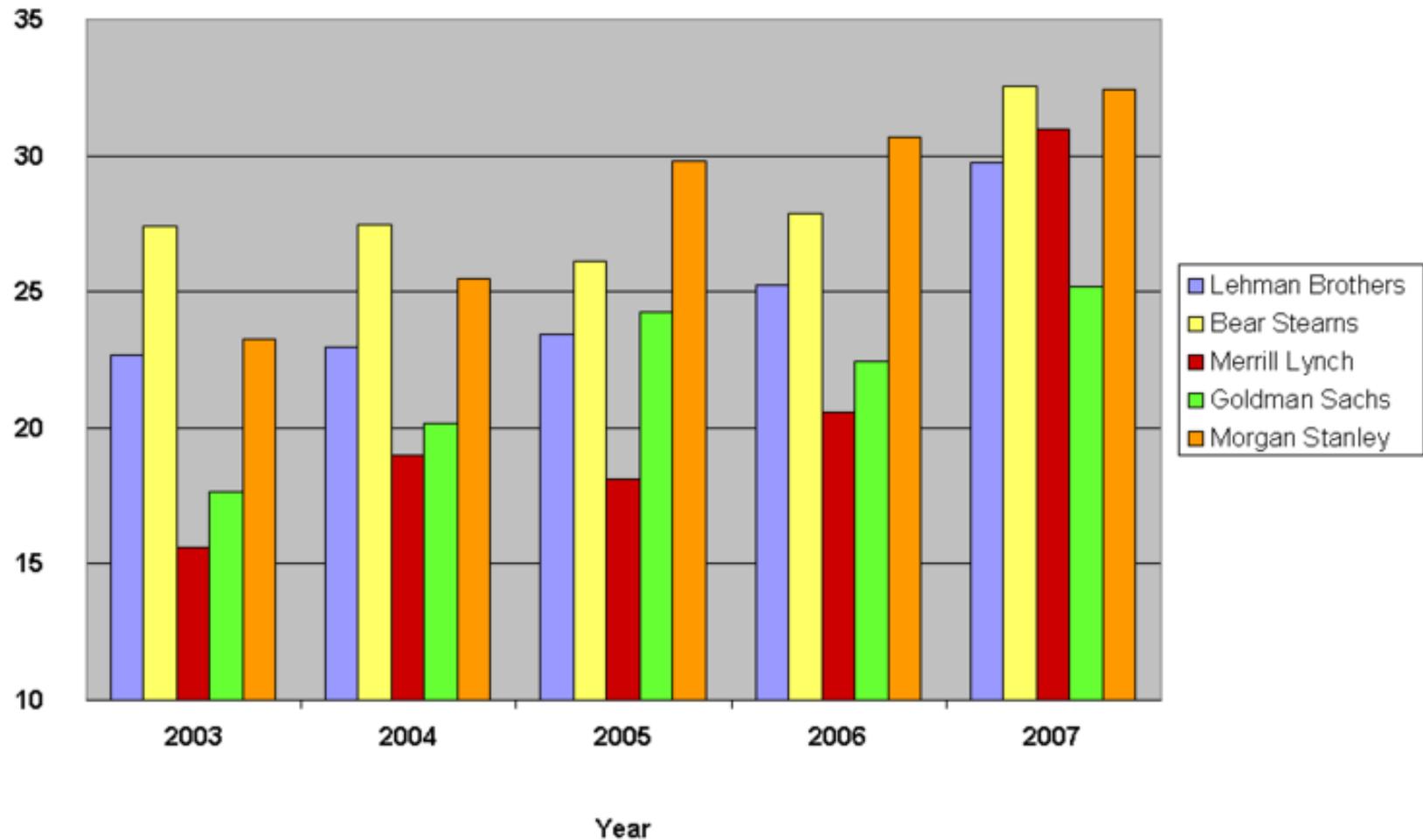


The End

- Regulators were questioning the leveraged position of the financial firms
 - Financial leverage has the effect of magnifying performance.
 - Indifferent to the kind of performance

Leverage Ratios For Major Investment Banks

The leverage ratio is a measure of the risk taken by a firm; a higher ratio indicates more risk. It is calculated as total debt divided by stockholders equity. Each firm's ratio increased between 2003-2007.



Source Data: Company Annual Reports (SEC Form 10K)

The End – Wall Street's Bailout

2008 was the year the world changed.

- Introduction of new terms
 - To big to fail -- Troubled Asset Recovery Program (TARP)
 - New Normal -- Quantitative Easing (QE x3)
 - Other Than Temporary Impairment (OTTI)
- Financial giants who stumbled
 - Citi -- GMAC
 - Bank of America -- AIG

The End – Wall Street's Bailout

- Financial giants who tumbled
 - Lehman Brothers
 - Bearn Sterns
 - Countrywide
 - Washington Mutual
 - Merrill Lynch
 - GreenPoint Financial
 - Fannie Mae and Freddie Mac

The End – Wall Street's Bailout

- Dodd Frank Wall Street Reform and Consumer Protection Act
- Creation of the Federal Housing Finance Agency
 - A new regulator for Fannie and Freddie and the Federal Home Loan Banking System
- Creation of the Consumer Financial Protection Bureau
 - Created amidst complaints of unfair lender practices

The End – Main Street’s Fallout

Gang Member # 1: Ability-to-Repay (ATR)

Gang Member # 2: High-Cost Mortgage (HCM)

Gang Member # 3: Escrow

Gang Member # 4: Servicing

Gang Member # 5: Appraisals for High-Risk Mortgages

Gang Member # 6: Copies of Appraisals

Gang Member # 7: Mortgage Loan Originator

Compensation

The End – Main Street’s Fallout

Gang Member #1 - ATR

Ability to Repay Standard

- Part of the changes from the Dodd Frank Wall Street Reform and Consumer Protection Act
- Generally require creditors to make a reasonable, good faith determination of a consumer’s ability to repay any consumer credit transaction secured by a dwelling
- Puts limits prepayment penalties.
- Requires creditors to retain evidence of compliance with the rule for three years after a covered loan is consummated.
- Establishes certain protections from liability under this requirement for “qualified mortgages.

The End – Main Street’s Fallout

Gang Member #1 - ATR

- ATR standards
 - Cap of fees
 - Requires lenders to verify income is able to support proposed debt
 - Requires lenders document and keep income verification
 - Put penalties on lenders how do not comply

The End – Main Street’s Fallout

Gang Member #1 - ATR

Lender and industry comments

- Rule will displace up to 15% of the market
- Self employed borrowers, borrowers where a portion of qualifying income is derived from commission, bonus or other variable forms. (sales positions, C level positions, self employed borrowers, ect.)
- Less than perfect credit borrowers. Cost of the credit may push up against the limit and lenders will forego the loan rather than risk non-compliance

The End – Main Street’s Fallout

Gang Member #2 – High Priced Mortgage

High Priced Mortgage

This regulation implements the following requirements:

- Prohibits prepayment penalties and balloon payments, with limited exceptions (certain types of loans made by creditors serving rural or underserved areas)
- Prohibits fees for modifying loans, caps late fees at four (4%) percent of the past due payment, restricts the charging of payoff statement fees, and prohibits certain other practices, such as encouraging a consumer to default on an existing loan to be refinanced by an HCM;

The End – Main Street’s Fallout

Gang Member #2 – High Priced Mortgage

- Requires consumers to receive homeownership counseling before taking out an HCM
- Mandates HELOC creditors to assess ability to repay.
- With respect to counseling, requires lenders to provide a list of homeownership counseling organizations to consumers shortly after they apply for a mortgage loan (not just an HCM) and implements a new requirement that creditors obtain confirmation of homeownership counseling from first-time borrowers on loans permitting negative amortization (not just HCMs).

The End – Main Street’s Fallout

Gang Member #3 - Escrow

The revised regulation:

- Amends existing Regulation Z provisions that require creditors to establish and maintain escrow accounts for at least one year after originating higher-priced mortgage loans (HPMLs) to generally require that the accounts be maintained for five years;
- Establishes an exemption for small creditors that operate predominantly in rural or under-served areas

The End – Main Street’s Fallout

Gang Member #3 - Escrow

- Provides an exemption from escrowing for insurance premiums for condominium units to other situations where individual consumer’s property is covered by a master insurance policy.

The End – Main Street’s Fallout

Gang Member #4- Servicing

This regulation mandates that servicers must

- Correct errors asserted by mortgage loan borrowers
- Provide certain information requested by borrowers
- Implement various protections in connection with force-placed insurance

The End – Main Street's Fallout

Gang Member #4 - Servicing

- Establish reasonable policies regarding delineated objectives (i.e., delinquent mortgage loans)
- Requires informing borrowers about mortgage loss mitigation options
- Introduces a policies requirement for providing borrowers with "continuity of contact" with servicer personnel capable of performing certain functions
- Requires the servicer to evaluate a borrower's application for available loss mitigation options

The End – Main Street’s Fallout

Gang Member #5 – Appraisals & High Priced Mortgages

- This regulation implements requirements pertaining to appraisals for high-risk mortgages (HRMs). The Final Rule permits a creditor to extend an HRM only if
 - the creditor obtains a written appraisal,
 - the appraisal is performed by a certified or licensed appraiser, and
 - the appraiser conducts a physical visit to the interior of the property.
- At the time of application, the consumer must be given a specific notice that
 - states the purpose of the appraisal,
 - states the creditor will provide the applicant a copy of any written appraisal, that
 - the creditor may charge the applicant for the appraisal, and that
 - the applicant may choose to have a separate appraisal conducted at his or her own expense.

The End – Main Street’s Fallout

Gang Member #5 – Appraisals & High Priced Mortgages

- The creditor must provide the consumer with a free copy of any written appraisals at least three business days before loan closing.
- A new appraisal is required for “flipped properties”.
 - Flipped properties defined. Where the seller acquired the home within 180 days before the date of the consumer’s purchase agreement and the consumer is paying a price that exceeds the seller’s acquisition price by 10 percent if the seller acquired the property within the past 90 days or exceeds the seller's acquisition price by 20 percent if the seller acquired the property between 91 and 180 days earlier,

The End – Main Street’s Fallout

Gang Member #6 – Copies of Appraisals

This Final Rule amends Regulation B, the implementing regulation of the Equal Credit Opportunity Act. Creditors are required to provide free copies of appraisal and valuation reports prepared in connection with any closed-end loan secured by a first lien on a dwelling and, in certain situations, requires second appraisals.

- For a first lien on a dwelling:
 - Creditors must notify applicants within three business days of receiving an application of their right to receive copies of any appraisals
 - Creditors must provide applicants with copies of each appraisal and other written valuation promptly upon completion or three business days before consummation

The End – Main Street's Fallout

Gang Member #6 – Copies of Appraisals

- Applicants may waive the timing requirement for providing these copies, but creditors still must give consumers copies of all appraisals and valuations at or before consummation or account opening or, if the transaction is not consummated or account not opened, no later than 30 days after the creditor determines that the transaction will not be consummated or the account not opened
- Creditors may not charge for copies of appraisals and other written valuations, but they are permitted to charge "reasonable fees" for the cost of the appraisals or valuations (unless applicable law provides otherwise).

The End – Main Street’s Fallout

Gang Member #7 – Loan Officer Compensation

- The Final Rule addresses
 - The qualifications of, and registration or licensing of loan originators,
 - Compliance procedures for depository institutions,
 - Mandatory arbitration provisions, and
 - The financing of single-premium credit insurance.

The End – Main Street’s Fallout

Gang Member #7 – Loan Officer Compensation

The regulation contains these elements:

- Prohibition against compensation based on a term of a transaction
- Prohibition against dual compensation
- No prohibition on consumer payment of upfront points and fees
- Loan originator qualification and identifier requirements
- Prohibition on mandatory arbitration clauses and single premium credit insurance

Summary

- Beginning – Government as facilitator and regulator
- End of the Beginning – Government’s role as a regulator declined due to:
 - New players in the market
 - Deregulation
- Beginning of the End -- Government fell asleep at the wheel while private industry was allowed to wreak havoc

Summary

- The End – Government returns with new and more restrictive regulations that have the potential to curtail the housing industry

Summary

After 76 years of evolution, the mortgage industry, has come full circle. Today, the mortgage industry is under as much, if not more regulatory burden than existed in the 1940's.

QUESTIONS

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