

MORTGAGE MONEY: REGULATED LENDERS

KEY TERMS AND PHRASES

Community Reinvestment Act	Mortgage pools
Comptroller of the Currency	Office of Thrift Supervision (OTS)
Consumer Financial Protection Bureau	Primary mortgage market
Credit unions	Regulated lenders
Federal Deposit Insurance Corporation (FDIC)	Resolution Trust Corporation (RTC)
Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)	Savings banks
Life insurance companies	Secondary mortgage market
Mortgage debt outstanding	Time deposit
	Wall Street Reform and Consumer Protection Act
	Warehouse lines of credit

LEARNING OBJECTIVES

At the conclusion of this chapter, students will be able to:

- Describe the mortgage credit market and its common sources of funding
- Differentiate between the primary and secondary mortgage markets
- Identify the roles of the various regulated mortgage lenders and their sources of funding
- Explain the differences between mortgage lenders funded by FDIC-insured deposits and those not funded by insured deposits
- Understand the role of the federal regulation commonalities and the evolution of government policies encouraging home ownership and consumer protection

INTRODUCTION

While the money that funds mortgage loans comes from a number of sources, most originates from private sources, including individual and company savings such as passbook savings accounts, money market accounts, and certificates of deposit, as well as premium reserves for policyholders held by life insurance companies, retirement programs such as IRA and Keogh accounts, and various mutual funds, plus the huge and growing pool of pension funds, sovereign funds, and liquidity interventions by central banks of large developed countries.

Up until about 2007, there was a common misconception that most funding for mortgages came from the federal government. Certainly the federal government did and still does have a number of direct-loan programs directed toward farmers, but this is only a very small percentage of the total loan market. Most states and some cities have housing agencies that offer direct loans and subsidy assistance, primarily for low-income home buyers. Various federal government agencies do offer underwriting programs that encourage private sources to fund loans, but these are in the form of guarantees rather than government money. The federal underwriting agencies charge fees for their guarantees with the expectation of making a profit and not burdening taxpayers. It should be noted that one of the biggest changes in the percentage of mortgage funding coming from the sources above has been that from financial institutions, investment funds, and individuals outside the United States during the period from 2001 to 2011. The recent financial crisis and the federal government's move to put Fannie Mae and Freddie Mac into conservatorship has made the Federal Reserve Bank the primary facilitator of funding for mortgage lending from 2008 to 2013. The significance of this change is more fully discussed in Chapter 1.

THE MORTGAGE CREDIT MARKET

In the credit market, the demand for mortgage money competes with all other demands for borrowed funds. While the mortgage share of this market fluctuates, it normally commands 20-25% of the total credit available each year. Total **mortgage debt outstanding** at the end of the 3rd quarter of 2014 totaled over \$13,360 billion—the second largest single class of debt in this country. Only the total U.S. federal debt exceeds this demand for credit.

Analysis of Mortgage Debt

The term *mortgage debt* includes all kinds of loans secured by mortgages and all types of lenders handling these loans. Mortgage debt includes long-term residential loans, short-term construction loans, and warehouse lines of credit used by mortgage companies. To better clarify how this debt is distributed, Table 3-1 identifies the four major categories of mortgage debt by type of loan. Clearly, residential loans dominate the market with more than three-fourths of the total debt outstanding—a percentage that has held steady for two decades. Farm loans continue to decline in both dollar amount and as a percentage of the total debt.

Analysis of Loan Sources

The mortgage loan analyst must distinguish between those making mortgage loans and those holding mortgage loans; they are not necessarily the same. Loan originators make the loans. Some originators hold these loans in portfolio—meaning as their own investments in income-producing assets. From 2000 to 2008, most originators sold their loans within a few months to secondary market investors dominated by private mortgage conduits and Ginnie Mae securities.

Table 3-2 shows the percentage of mortgage loans held by the principle lender sources. It compares the percentages held in 1998 with those at the end of the 3rd quarter of 2014 to illustrate how the market has shifted. The migration of mortgage lending away from savings associations began over 30 years ago. Now the major source for residential loans

TABLE 3-1 Major Categories of Mortgage Debt 1998 & 2014 (in billions of dollars)

	1998		2014 ¹	
	Amount	Percent	Amount	Percent
Total mortgage debt	\$5,782	100%	\$13,360	100%
Residential (1- to 4-family)	4,376	76	9,855	74
Apartments (multifamily)	362	06	969	7
Commercial	949	16	2,354	18
Farm	95	02	182	01

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¹Federal Reserve Bank. Mortgage Debt Outstanding, 3rd Quarter 2014 Report, released December 2014. Accessed Dec. 22, 2014 at <http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm>

Table 3-2 Mortgage Debt as Held by Class of Lender

A Comparison from 1998 to 2014 (in billions of dollars)

Lender Source	1998		2014	
	Amount	Percent	Amount	Percent
All holders	\$5,782	100%	\$13,360	100%
Depository institutions	1,981	34	4,124	31
Life and P&C insurance co's	212	4	377	3
Federal and related	292	5	4,972	37
Mortgage pools	2,632	46	2,761	21
Finance co's, REIT's and others	665	11	1,126	8

Source: © 2016 OnCourse Learning

has shifted from **mortgage pools**, which serve as collateral for the issuance of mortgage-backed securities issued by federal and related funding sources such as the Government-Sponsored Enterprises, primarily Fannie Mae and Freddie Mac.

THE MORTGAGE MONEY MARKET

The market for mortgage money functions at two separate levels: one is the loan origination market, called the **primary mortgage market**; the other is the **secondary mortgage market**, consisting of investors who buy mortgage loans. For the borrower, the source of funds is the primary market, where many lending companies compete for business. These companies include regulated lending institutions such as Wells Fargo, mortgage companies such as PHH Mortgage Corporation, commercial credit companies such as Aditya Birla Nuvo Limited, investment bankers such as Morgan Stanley Incorporated, finance houses such as HSBC Household Finance, Lending Tree LLC, large home builders, and consumer credit companies such as LendingClub Corporation.

The secondary market is where loan originators sell their loans, thus recovering cash to originate more loans. Many companies and trust funds, some pension funds, and others purchase these loans. Federal underwriting agencies such as Fannie Mae and Freddie Mac are mistakenly believed to make up the entire secondary market.

While these institutions are indeed big participants and buy or underwrite a little more than 65% of all residential loans each year, their major contribution to the secondary market is to guarantee loan pools as a means of providing credit enhancement for mortgage-backed securities. Prior to the recent conservatorship of Fannie Mae and Freddie Mac orchestrated by Secretary of the Treasury Hank Paulson in 2008, there had not been any government money at risk in Fannie Mae or Freddie Mac mortgage loans pledged as security for their bonds or MBS. Fannie Mae had been a government agency for 30 years when it was privatized in 1968, and Freddie Mac was created in 1970 with the same type of private charter to which Fannie Mae had transitioned, and from 1968, Fannie Mae no longer had any securities or debt outstanding that was guaranteed or insured by the federal government. Instead, it was private money—in the form of savings deposits, insurance reserves, pension fund cash, and funds from foreign investors—that provided most of the money to fund mortgage loans until 2008, when interventions by central banks added liquidity funding facilities. The secondary market will be further examined in Chapter 5.

THE PRIMARY MARKET

The loan origination market is composed of borrowers and lenders. Negotiation for a loan at this level involves a discussion of the interest rate and discount. How the requirements for loan qualification are determined depends on who the lender is and whether or not the loan will be sold to secondary-market investors. Regulated lenders must adhere to the rules set by their regulatory authority. Unregulated lenders are not as restricted. If a loan is intended for sale rather than to be held by the lender as its own investment (held “in portfolio”), the loan must meet the secondary-market purchaser’s requirements.

First, let us examine the nature of the lenders who deal one-on-one with borrowers—the loan originators. In this chapter, we will examine regulated lenders and the constraints on their lending practices. Chapter 4 will cover other loan originators, including mortgage companies, the loan programs that allow government agencies to make direct mortgage loans, and other primary-market lenders.

Since 1995, loan origination has become more dependent on automated loan analysis, which involves a computer program using artificial intelligence to help analyze a loan application (more fully described in

Chapter 14). This practice actually began in the secondary market with the large purchasers of loans such as Fannie Mae and Freddie Mac as a method of expediting their own loan analyses. As the next chapter will explain, it is even possible for an individual to negotiate a mortgage loan over the Internet. Prior to the passage of the Wall Street Reform and Consumer Financial Protection Act of 2010 (“Dodd-Frank Act”), regulated lenders handled about 75% of the mortgage loans. Since the passage of the Dodd-Frank, nearly any entity involved in mortgage lending—whether a depository or non-depository institution—falls into the category of regulated lenders by the Consumer Financial Protection Bureau (more on the Dodd-Frank Act and the Consumer Financial Protection Bureau later in this chapter). Lenders today continue to assist people in arranging access to the money needed to purchase or refinance real estate under a more structured, regulatory environment.

Regulated Lenders

Regulated lenders are those depository institutions and life insurance companies that are subject to various government regulatory agencies. This class of lender is limited in many ways: in the kind of loans the entity is allowed to make, by the percentage of total assets that can be held in certain types of loans, in the kind of mortgage repayment plans the entity can offer, and by the qualifications for borrowers and for property that is pledged as collateral. Because a number of different regulatory authorities are involved, including separate state and federal chartering systems, there is an overlap of authority, and no countrywide uniform standards that can be clearly defined.

For many years, regulated lenders dominated the mortgage market, particularly the market for home loans. About 75% of the money for residential mortgage lending came from savings accounts held by institutional, or regulated, lenders. This source of money began to disappear, however, as an escalation of interest rates and alternative investments such as money market mutual funds began siphoning cash out of lower interest-bearing savings association deposits. With their depositors’ money invested in long-term mortgage loans, depository institutions were caught in a serious cash shortage dilemma. The late 1980s saw the collapse of many savings associations, and this particular source began withdrawing from originating long-term, fixed-rate mortgages in order to maintain their portfolios held on their balance sheets.

Although regulated lenders have reduced their investments in the mortgage market (that is, holding loans in portfolio), they are still major players in the primary market. Some still hold loans as sound portfolio investments, while others originate loans that are sold to investors. Most regulated lenders retain the loan servicing function on their loan originations; it involves collection of monthly payments and proper disposition of the money. During the past five years, there has been a consolidation of mortgage loan servicing, and the field is no longer dominated by non-depository institutions, but rather by depository institutions, the largest of which are Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo N.A. However, now some sell this function to specialized servicing companies like American Home Mortgage Servicing, Inc., or outsource to firms like ClearSpring Loan Services.

Following is a discussion of the four major classes of regulated lenders: (1) savings institutions, (2) commercial banks, (3) credit unions, and (4) life insurance companies.

Savings Institutions

The term *savings institutions* describes both savings associations and mutual savings banks (now called simply *savings banks*). Because both these institutions were initially limited to holding only time deposits (savings accounts), they also acquired the combined name *thrift institutions*, or *thrifts*.

A **time deposit** is one that does not permit withdrawal on demand, but instead usually requires a waiting period of 14 to 30 days depending on which regulatory authority is in control. In addition to the obvious time factor in savings certificates and certificates of deposit that give a withdrawal date or time period on their face, all passbook savings accounts are classed as time deposits. Even though the withdrawal limit on time deposits exists, few institutions attempt to use it under normal conditions. To delay a withdrawal would most likely discourage further deposits by customers. Nevertheless, it is this access to the more stable time deposits that has provided justification for the practice of savings institutions to make long-term mortgage loans.

Savings Associations

The original purpose of savings associations was to provide a source of money for home loans. As a result, in their earlier years, some were called

building societies. Congress established the Federal Home Loan Bank Board (FHLBB) in 1934, giving it the authority to charter new federal savings associations. The Board required all federal charters to keep at least 80% of their deposit assets in residential loans (including multi-family housing loans).

As recently as 40 years ago, savings associations were limited by law to paying an interest rate of 5.50% on passbook savings accounts (according to Federal Reserve Regulation Q), which was well below market rates at that time. To help overcome this problem, new savings certificates were introduced that allowed payment of higher rates for longer-term deposits. The result of this and other factors was a rapid increase in the cost of funds. Indeed, the national average cost of funds for FSLIC-insured savings associations rose from 7.87% at the end of 1979 to 11.58% at the end of 1981. At that time, savings associations held most of their mortgage loans in portfolio, and the fixed income generated by low-interest, long-term mortgage loans failed to keep pace with the rising cost of funds.

In 1980, Congress passed the Depository Institutions Deregulation and Monetary Control Act, which substantially altered many rules that had formerly distinguished the various kinds of depository institutions from each other. No longer were savings associations firmly committed to making mostly residential loans. New rules allowed them to expand their investment portfolios to many new kinds of loans, including higher-risk investments. In addition, they could now offer their customers checking account services, credit card accounts, and the advice of trust departments—services formerly restricted to commercial banks. While the intention of Congress was to help savings associations recover from the dilemma created by escalating interest rates, they overlooked the role played by federal deposit insurance.

To cope with massive losses on insured deposits, Congress enacted legislation, signed by the first President Bush on August 9, 1989, in the form of the **Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)**, which created an overhaul of banking practices with the primary goal of restructuring the savings and loan association system. The 900-plus-page document touched many aspects of mortgage lending, including federal and state licensing of appraisers, setting minimum capital requirements, and providing more stringent enforcement of banking regulations.

In 1996, Congress passed legislation that set the stage for the eventual elimination of savings institutions, which would be re-chartered as banks. The two **separate deposit insurance funds** (SAIF for savings associations and BIF for commercial banks and savings banks) were merged into one fund under FDIC management. To facilitate this merger, savings associations and a few banks agreed to pay \$4.7 billion into the SAIF fund, which had been the weaker of the two funds. Two reasons for the weakness of the savings association fund were the declining number of S&Ls (below 1,200 in 2014) and the annual \$780 million paid by this fund on government bonds issued to help bail out troubled associations.

With the additional cash added mostly by savings associations, the deposit insurance funds had reached the legal protection requirement (\$1.25 for each \$100 of insured deposits), and therefore most insured institutions were no longer required to pay an assessment to the fund except for the \$2,000 per year membership fee.

Savings Association Regulatory Authorities

Office of Thrift Supervision (OTS)—Now Merged Into the Office of the Comptroller of the Currency

Until the re-chartering of savings associations as banks, federal regulatory authority for savings associations was held by the **Office of Thrift Supervision (OTS)**. Section 312 of the Dodd-Frank Act mandated the merger of OTS with the Office of the **Comptroller of the Currency (OCC)**, the Federal Deposit Insurance Corp. (FDIC), the Federal Reserve Board, and the Consumer Financial Protection Bureau (CFPB) as of July 21, 2011. The OTS ceased to exist on October 19, 2011. An arm of the Treasury Department under the OCC, the OTS at one time replaced the FHLBB as regulator for the associations. Its authority extended to both federal- and state-chartered institutions that carried federal deposit insurance.

Federal Housing Finance Board (FHFB)

OTS was not given all the authority formerly held by the FHLBB. The new Federal Housing Finance Board was assigned as overseer of mortgage lending for the 12 regional Federal Home Loan Banks. In addition, the FHFB is responsible for handling statistical data for the housing industry.



Federal Deposit Insurance Corporation (FDIC)

The FDIC remains under the Treasury Department and now has authority to manage both the bank deposit insurance fund and the savings association insurance fund. Before the enactment of FIRREA in 1989, the savings associations' insurance fund was managed by the Federal Savings and Loan Insurance Corporation (FSLIC). It was this fund that became insolvent, not the bank's FDIC fund, necessitating a taxpayer bailout of the system. The FSLIC was dissolved by FIRREA.

The Emergency Economic Stabilization Act of 2008 temporarily raised the basic limit on federal deposit insurance coverage from \$100,000 to \$250,000 per depositor. It was initially set to expire in December 2009. On November 9, 2010, the FDIC Board of Directors (the "Board") issued a final rule (the "November Final Rule") to implement Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA"), which provides temporary, unlimited, deposit insurance coverage for noninterest-bearing transaction accounts at all FDIC-insured depository institutions. The separate coverage for noninterest-bearing transaction accounts became effective on December 31, 2010, with a termination date of December 31, 2012. All funds in a noninterest-bearing transaction account are insured in full by the Federal Deposit Insurance Corporation from December 31, 2010, through December 31, 2012. This temporary, unlimited coverage is in addition to, and separate from, the coverage of at least \$250,000 available to depositors under the FDIC's general deposit insurance rules.

The term "noninterest-bearing transaction account" includes a traditional checking account or demand deposit account on which the insured depository institution pays no interest. It also includes Interest on Lawyers Trust Accounts ("IOLTAs"). It does not include other accounts, such as

traditional checking or demand deposit accounts that may earn interest, NOW accounts, or money-market deposit accounts.

Where Are We Now?

What You Need to Know

The Emergency Economic Stabilization Act of 2008, enacted on October 3, 2008, is commonly referred to as a bailout of the U.S. financial system. This law was enacted in response to the subprime mortgage crisis, and authorized the United States Secretary of the Treasury to spend up to \$700 billion to purchase distressed assets, especially mortgage-backed securities (MBS), and make capital injections into banks. However, the plan to purchase distressed assets, known as the Troubled Asset Relief Program (TARP), has since been abandoned. Both foreign and domestic banks are included in the program. The original proposal was submitted to the United States House of Representatives with the purpose of purchasing bad assets, reducing uncertainty regarding the worth of the remaining assets, and restoring confidence in the credit markets.

Supporters of the plan argued that the market intervention called for by the plan was vital to prevent further erosion of confidence in the U.S. credit markets and that failure to act could lead to an economic depression. Opponents objected to the plan's cost and rapidity, pointing to polls that showed little support among the public for "bailing out" Wall Street investment banks, and claiming that better alternatives had not been considered and that the Senate had forced passage of the unpopular version through the House by "sweetening" the bailout package.

"This plan can be described as a risky investment, as opposed to an expense. The MBS within the scope of the purchase program have rights to the cash flows from the underlying mortgages. As such, the initial outflow of government funds to purchase the MBS would be offset by ongoing cash inflows represented by the monthly mortgage payments. Further, the government eventually may be able to sell the

assets, though whether at a gain or loss will remain to be seen.”² A key challenge lay in valuing the purchase price of the MBS, which is a complex exercise subject to a multitude of variables related to the housing market and the credit quality of the underlying mortgages. The ability of the government to offset the purchase price (through mortgage collections over the long run) would depend on the valuation assigned to the MBS at the time of purchase. It turned out that most of the TARP funds were used to purchase nonvoting blocks of equity in many of the nation’s troubled financial institutions to shore up their capital positions, rather than to buy up toxic mortgage assets.

The bailout option finally used was primarily aimed at shoring up the capital positions of financial institutions through investments made by the U.S. Treasury Department in purchasing the preferred stock of banks. A vast majority of this investment has been paid back by the institutions. The U.S. Treasury Department sold its investments in three banks in November of 2014. At that time, 39 banks still owed TARP funds; many of these were past due in their TARP dividend payments on the funding they received under the Capital Purchase Program. These financial institutions that are past due represent about \$381.2 million or about 0.2% of the \$204.9 billion initially given to 707 banks and financial institutions,³ less than a typical seller would expect to be uncollectible.

Resolution Trust Corporation (RTC)

The **Resolution Trust Corporation** filled an important role in handling the liquidation of failed savings associations in the late 1980s and into the mid 1990s. Created by FIRREA in 1989, the RTC was given authority to take the necessary steps to sell or liquidate failing thrifts.

The RTC was a receiver, not a regulator, and was responsible for those assets assigned to it by either the OTS or the FDIC. The RTC could close

²Wikipedia. “Emergency Economic Stabilization Act of 2008.” Accessed Dec. 26, 2014 at http://en.wikipedia.org/wiki/Emergency_Economic_Stabilization_Act_of_2008

³Krantz, Michael. “40 Banks Late on their TARP Bailout Payments.” *USA Today Money*, April 20, 2014. Accessed Dec. 26, 2014 at <http://americasmarkets.usatoday.com/2014/06/20/40-banks-late-on-their-tarp-bailout-payments/>

and liquidate a failed institution or it could take over its management under a conservatorship. The RTC inherited some overvalued loan collateral and quite a bit of inadequate loan documentation in its takeover of insolvent associations. These problems made fast resolution difficult. Since the core of the RTC's personnel initially consisted of FDIC employees, its remaining functions and personnel were transferred back to the FDIC. The remaining problems of this agency were transferred to the FDIC in July 1995 and the RTC was dissolved.

Savings Banks

Savings banks originated during the early years of the United States when most people traded in cash and needed a place to deposit their surplus for safekeeping. Our modern-day "check society" was still a long way off; there was little need for checking accounts.

For many years thereafter, savings banks (formerly called "mutual savings banks" because most were owned by their depositors) operated with good success in the northeastern part of the country. They were located particularly in New York and Massachusetts, with a few in the far northwest. Originally, these institutions were all state chartered.

Because of the emphasis on savings account deposits over demand deposits, savings banks looked with favor on longer-term mortgage loans. As a result of their location in generally cash-rich areas of the country and the conservative nature of their investment policies, many savings banks favored FHA and VA loans. There was no restriction on making this kind of loan out of state, and savings banks purchased these loans from originators all over the country. In recent years, however, lending policies shifted away from individual mortgage loans to investing in federally underwritten mortgage-backed securities.

The Federal Home Loan Bank Board has full authority over federally chartered, stockholder-owned savings banks. When the FSLIC was faced with major problems disposing of failed savings associations in the mid to late 1980s, it undertook a new policy. Instead of dissolving troubled savings associations, it would selectively merge four or five such institutions into one and re-charter the operation as a "federal savings bank," or FSB. There were some advantages to this procedure. It postponed the need for bailout cash in the hope that the reorganized entity might resolve its own problems. Moreover, it took direct regulation away from state banking commissions that may have been in some conflict with federal deposit

insurance policies. Furthermore, the cost of deposit insurance was much less at that time for a savings bank than for a savings association, which gave the newly reorganized groups lower operating costs. In the late 1980s, commercial banks and savings banks, both insured by the FDIC, were paying an 8.33 cent premium per \$100 of insured deposit, while savings associations were paying nearly double that amount, with further increases expected.

The 1980 Depository Institutions Deregulation Act altered the way the banking system could serve the public. One of the changes was formal approval for savings associations and savings banks to offer checking accounts. In addition, the door was opened for these institutions to make other kinds of loans. The result of these changes was that savings banks and savings associations could offer services very similar to those of commercial banks.

Commercial Banks

The original purpose of U.S. commercial banks was to serve the business community and government. They were expected to provide the services of checking accounts, including the transfer of money, and the protection available in a depository institution.

Initially, states chartered their own banks and, prior to the Civil War, granted commercial banks the authority to issue their own currency. It was not until the passage of the National Bank Act in 1863 that issuance of currency was placed under the control of the federal government. The National Bank Act also authorized federally chartered banks to be organized under the regulatory authority of the Comptroller of the Currency. Interestingly, later amendments to this law prohibited national banks from making real estate loans, a restriction that was rescinded in 1913.

The creation of the Federal Reserve Bank (the Fed) in 1913 brought nationally chartered banks under the credit regulations of the Fed and established terms of cooperation between them. The act establishing the Fed also allowed national banks to make real estate loans within certain specified limits. The regulatory authority over commercial banks is a separate system from those regulating savings associations and is also a dual system, with both federal and state governments issuing charters and regulations. In an effort to reduce conflicts between overlapping authorities, FIRREA placed all depository institutions that carry federal deposit insurance under federal regulation.

Limits on Real Estate Loans

In 1991, Congress passed the Federal Deposit Insurance Corporation Improvement Act, which, among other things, required the four federal banking regulators (Federal Reserve Bank System, FDIC, the Office of Thrift Supervision and the OCC) to establish limits for various categories of real estate loans. It should be noted that in 1980, the Bank Deregulation Act had eliminated loan-to-value limits for real estate loans that had been in place since the Depression years. The limits that became effective in March 1993 are as follows:

- There is no ceiling on one- to four-family property loans except that loans over 80% of the market value of the collateral must have private mortgage insurance.
- Certain loans are exempt from limits, such as those guaranteed by the federal government; problem loans that must be renewed, refinanced, or restructured; and loans to facilitate the sale of foreclosed properties.
- Other limits are:

Loan Category	Loan-to-Value
Improved property	85%
One- to four-family construction	85%
Nonresidential construction	80%
Land development	75%
Raw land	65%

Note: A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied, one- to four-family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90% at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

The National Credit Union Administration, which administers the National Credit Union Insurance Fund, has joined in requiring the same loan-to-value limits for its credit unions.

Lending Policies

Because of the business orientation of commercial banks, the banks' lending policies have favored short-term loans for specific business purposes.

These institutions have not been very active in the long-term home loan market. Some only make mortgage loans through subsidiary mortgage companies, in part because substantial shares of a commercial bank's deposits are demand-type (checking accounts), and banks are limited in allowing such money to fund long-term loans. Growth in secondary mortgage market funding through the sale of mortgage-backed securities is changing this policy, however. The ability of large commercial banks to originate long-term residential loans and then fund them through the sale of securities is opening a new market that does not commit the banks' own deposit assets. Loan origination expands the use of a bank's credit expertise and provides additional income from origination charges and servicing fees.

Certain kinds of shorter-term mortgage loans (less than the older, 30-year standard term) are more suited to commercial banks, as are lines of credit for mortgage companies and construction loans. In addition, commercial banks may handle some medium-term mortgage loans as needed by their business customers. The four kinds of lending activities that can be found in a commercial bank's mortgage operations are as follows:

Direct loans. Mortgage loans made for medium terms, such as 10 to 15 years, for good commercial customers.

Construction loans. The shorter-term, two- to three-year construction loans are attractive to banks due to higher returns. Larger banks are better able to employ the specialized talent necessary to monitor the disbursement of funds as construction progresses.

Warehouse lines of credit. A warehouse line of credit is a short-term revolving line of credit secured by recently closed residential real estate loans that allows mortgage bankers to fund loans in their own names. This funding source, also known as the warehouse lender or bank, generally offers the necessary funds through a revolving purchase agreement to a mortgage banking company for funding mortgages at closing. The warehouse lender will want to see that these loans have been pre-sold or covered by a commitment agreement in the secondary market to large institutional investors, and that they are maintained on the warehouse line until they are purchased by the investor. Warehouse line funding usually covers an approximately 15- to 30-day period between loan closing and the sale of the loans to the institutional investor. Some credit lines can run as long as six to 12 months when dealing with some of the special commitments that Freddie Mac offers.

Loan origination. Origination of home loans is a growing activity for commercial banks. Banks can initially fund these loans with their own deposit assets and then sell them to secondary-market investors. Another path open to the larger banks is to create their own loan pools that then serve as collateral for the private issuance of mortgage-backed securities. These securities are not underwritten by the federal government.

Regulation of Commercial Banks

Commercial banks can be chartered either by states or by the federal government. National charters (these are not called “federal charters” when commercial banks are involved) are issued by the Comptroller of the Currency, part of the U.S. Treasury Department. National charters must belong to the Federal Deposit Insurance Corporation (FDIC) and carry deposit insurance to protect depositors. State-chartered banks may join the FDIC system if they meet the necessary qualifications and accept such federal regulations as may apply; otherwise, they will not be granted a charter.

Commercial banks are responsible to an additional regulatory body. Besides the chartering agency and the deposit-insuring agency that normally provide regulation and periodic examination, commercial banks come under the jurisdiction of the Federal Reserve Bank Board as regards their credit policies. The Federal Reserve Bank is also responsible for setting reserve requirements for all depository institutions.

Credit Unions

Credit unions may be chartered by any group of people who can show a *common bond*. The bond has generally been that of a labor union, a company’s employees, or a trade association. However, a recent interpretation of this rule allowed the American Association of Retired Persons (AARP), which has some 37 million members, to form a credit union. The common bond here is the fact that all members are over 50 years of age. Over 7,094 credit unions were operating in this country at the end of 2011.⁴

Credit unions offer a special attraction as depository institutions because they pay no income taxes. Classed as nonprofit organizations, most credit unions are relatively small and often managed by nonprofessional personnel. Their primary lending consists of small loans to their

⁴National Credit Union Administration. 2012 *Directory of Federally Insured Credit Unions*. Online version available at <http://www.ncua.gov/Legal/Documents/Reports/CUDIR2012.pdf>