members for such purposes as buying a car or furniture. When savings associations met with highly publicized reversals three decades ago, many individuals transferred their savings to credit unions, which now have over 90 million members.

In 1978, federally chartered credit unions were authorized to make 30-year mortgage loans; prior to that date, the limit of their loan term was 12 years. That same year, credit unions were authorized to sell loans to secondary-market investors while retaining the loan servicing function. Even then, there was little growth in this particular activity for the smaller unions because of the specialized nature of mortgage lending. The larger unions with professional staff are capable of, and do engage in, the business of making long-term mortgage loans.

The 1980 Depository Institutions Deregulation Act increased credit unions' authority to make all types of loans and to accept all kinds of deposits. Furthermore, these institutions have expanded the services they offer to include some that were formerly available only through their competitors. These services include safe deposit boxes, credit cards, and money market accounts. These extra services plus the tax-exempt status of credit unions may not be their only advantages; many members feel they gain a closer personal touch.

Because of the tax-exempt status and other advantages found in credit unions, bankers have tried to limit credit union expansion through a lawsuit contesting what is meant by the *common bond* required of credit union members. The suit reached the U.S. Supreme Court, which ruled on February 25, 1998, that federally chartered credit unions are limited to membership as originally defined by law.

Though the banks were the victors in this lawsuit, Congress then passed legislation to restore credit union membership guidelines to employees of companies with total personnel of 3,000 or less. This legislation adds the requirement that credit unions must adhere to the Community Reinvestment Act but does not change their nonprofit status. Some credit unions have chosen to elect a change in status, asking their members to vote to re-charter as savings banks or banks. This movement, along with mergers of credit unions, has reduced the number of credit unions from a high of around 18,000 to a little more than one-third that number today.

Regulation of Credit Unions

Credit unions can be either state or federally chartered. An independent agency of the federal government, the National Credit Union Administration

(NCUA) charters, regulates, and supervises the activities of federal credit unions. State charters adhere to their own state rules and laws.

Deposits in credit unions can be protected by the same kind of insurance as other regulated depository institutions. The federally chartered National Credit Union Share Insurance Fund, administered by the NCUA, covers deposits up to $250,000. Federal charters must offer this coverage, and state charters that qualify are eligible to join.

RESERVE REQUIREMENTS FOR DEPOSITORY INSTITUTIONS

Institutions handling deposits are required to hold a certain percentage of their deposit assets in a reserve account, making these funds unavailable for lending purposes and thus providing a back-up source of emergency money should one be needed. In the past, state-chartered institutions operated under their respective state laws governing reserve requirements, while national charters adhered to federal requirements. These regulations often differed as to the amount of reserves required and whether or not the reserves could earn interest. Furthermore, the Federal Reserve Bank Board had authority to alter reserve requirements for its own member banks, but not for nonmember state charters. Changing reserve requirements gave the Federal Reserve Bank one more tool with which to stabilize the national economy; however, it also created some inequities within the banking system, as the application of reserve requirements was not uniform.

Any institution holding reserves on deposit with the Fed has the right to borrow from the Fed at the discount rate of interest. The Fed's "discount window" is open for emergency use, but the money cannot be used as additional capital for ordinary lending purposes. Many exceptions to this last guideline have been made as a result of the recent financial crisis.

DEPOSIT INSURANCE

Savings associations, savings banks, commercial banks, and credit unions are all classified as depository institutions, meaning that they are specifically authorized by their charters to hold deposits for their customers. Governments treat this activity as a special kind of trust. When the Great Depression of the 1930s caused the collapse of about one-half of these institutions, savings were lost and depositor confidence was destroyed. To help restore that trust, the federal government created a deposit insurance system.

In 1934, Congress established the **Federal Deposit Insurance Corporation** (FDIC) to insure deposits to commercial banks and savings banks. At the same time, the government created the Federal Savings and Loan Insurance Corporation (FSLIC) to insure deposits in savings associations. Later, the National Credit Union Share Insurance Fund was set up to insure credit union deposits. Life insurance companies are not considered depository institutions and are not federally insured. However, a few states opted to establish their own deposit insurance funds for state-chartered institutions, and a few permitted private insurance companies to underwrite the risk. Several failures of state insurance funds occurred in the early 1980s; federal protection has proved to be more effective.

Reorganization of Deposit Insurance Funds

The 1989 Financial Institutions Reform, Recovery, and Enforcement Act dissolved the FSLIC and reorganized the deposit insurance system. A new Deposit Insurance Fund (DIF) was created, administered by the FDIC. Under the DIF, there are two separate insurance funds. One is the Savings Association Insurance Fund (SAIF), which replaced the insolvent FSLIC. The other is the Bank Insurance Fund, which is simply the old FDIC fund under a new name. Effective in 1994, Congress prohibited the FDIC from reimbursing depositors for accounts in excess of the $100,000 limit, an option that had been used in previous years to avoid further collapsing an already weakened banking system. The recent financial crisis once again brought to the fore the need to stabilize the depositor base in the U.S. banking system. On October 3, 2008, President George W. Bush signed the Emergency Economic Stabilization Act of 2008, temporarily raising the basic limit on federal deposit insurance coverage from $100,000 to $250,000 per depositor. This legislation provided that the basic deposit insurance limit would return to $100,000 after December 31, 2009; however, the passage of the Dodd-Frank Act in 2010 permanently raised the limit to $250,000.

Congress passed legislation that phased in the merging of the separate insurance funds (the BIF and the SAIF), retaining the FDIC as administrator. In addition, the legislation called for re-chartering savings associations as banks. This provision simplified some of the regulatory confusion and overlap that had existed in the banking system.

COMMUNITY REINVESTMENT ACT (CRA)

The **Community Reinvestment Act**, passed in the late 1970s, has gone through many changes, but its original purpose—to ensure that regulated depository institutions serve the needs of their communities—remains. It requires regulated institutions to publicize their lending services in their own communities and encourage participation in local lending assistance programs. Enforcement of these requirements is handled by the particular federal supervisory agency regulating the institution. There are four: (1) the Comptroller of the Currency, (2) the Federal Reserve Bank, (3) the FDIC, and (4) the Office of Thrift Supervision. Thus the act covers most of the nation's financial institutions. The penalty for failure to comply is a limitation on any approval that may be required from federal authorities by the offending institution.

The act requires that each institution undertake four procedures, as follows:

1. *Define the lender's community.* Each lender must prepare a map of the area it serves, which is the neighborhood from which it draws its deposits and into which it makes loans.
2. *List types of credit offered.* A list of credit services available from the institution must be submitted to the regulators and made available to the public; emphasis is on publicizing methods of borrowing rather than saving money.
3. *Post public notice and public comments.* Each relevant institution must post a notice in its place of business stating that the institution's credit performance is being evaluated by federal regulators. Furthermore, the notice should state that the public has the right to comment on the institution's performance and to appear at open hearings on any request for expansion.
4. *Report on efforts to meet community needs.* A periodic report must be made available to the public on the efforts of the institution to ascertain the credit needs of its community and the ways it is attempting to meet those needs.

CRA Amended by FIRREA

The 1989 FIRREA amended the Community Reinvestment Act, sharpening the performance ratings for regulated institutions and requiring

public disclosure of what each is doing to meet local needs. FIRREA also amended the 1975 Home Mortgage Disclosure Act, expanding its reporting requirements to include all mortgage lenders—both regulated and, for the first time, unregulated lenders. The purpose of these changes is to encourage greater participation in home buyer assistance programs through increased publicity of lenders' actual performance.

CRA Grading of Regulated Lenders

FIRREA requires that CRA ratings be made public for each institution, evaluating how well the entity:

1. Knows the credit needs of its community
2. Involves its board of directors in setting up and monitoring CRA programs
3. Informs the community about its credit services
4. Offers a range of residential mortgages, housing rehabilitation, and small business loans
5. Participates in government-insured, -guaranteed, or -subsidized loans
6. Distributes credit applications, approvals, and rejections across geographic areas
7. Avoids discrimination in its lending practices

The CRA grading consists of four categories: (1) outstanding, (2) satisfactory, (3) needs to improve, and (4) substandard compliance. Each institution's grade is publicized periodically, a practice that has proven to be a substantial incentive for compliance with CRA requirements. Furthermore, a satisfactory or better CRA rating is necessary to obtain regulatory approval of an institution's request for such activities as mergers, acquisitions, expansions, and siting new branches. Previously, third parties could petition regulatory agencies to deny approval of these activities for an institution with a poor CRA record. However, in January 1997, the Office of the Comptroller of the Currency issued a rule change that cut out such community groups, announcing that the OCC would send in its own team to review a bank's lending record and render a verdict.

In 1999, President Clinton signed into law the Gramm-Leach-Bliley Act, also known as the "Financial Services Modernization Act." This law extended the provisions of the CRA to those institutions wishing to use

a bank holding company as the vehicle for entering into the commercial banking business to the other lending practices within the banking holding company.

With the passage of the Higher Education Opportunity Act, Pub. L. 110-315, on August 14, 2008, each appropriate federal financial supervisory agency shall now consider, as a factor in assessing the record of a financial institution's CRA compliance, any and all low-cost education loans provided by the financial institution to low-income borrowers.

The incentive generated by the recent CRA requirements has spawned a new loan qualification pattern that will be examined under the umbrella term *affordable housing* in Chapter 9 as another kind of borrower-qualification standard.

ADDITIONAL FEDERAL REGULATION OF HOME MORTGAGE LENDING

Federal legislation passed in 1975 that was initially directed only toward regulated lenders has since been expanded to include independent mortgage companies. This legislation is called the Home Mortgage Disclosure Act (HMDA), and it requires most financial institutions to disclose the number of mortgage loans they make and the dollar amount of these loans by geographic area. The intent was to generate a statistical basis for judging if and where discrimination was prevalent in lending practices.

In 1989, FIRREA expanded its reporting requirements to include all home loan originators and information relating to the income level, racial characteristics, and gender of mortgagors and mortgage applicants. This requirement covers both loans originated and applications rejected. In addition, disclosure is required regarding to whom the loans are sold. The intent is to determine what loan originators are doing with the loans they make. For this purpose, each of the federal underwriters of mortgage pools (Ginnie Mae, Fannie Mae, Freddie Mac, and Farmer Mac) is classified separately.

Information generated through HMDA is enabling Congress to take steps toward further restructuring of the home loan market. In the 1992 Federal Housing Enterprises, Financial Safety, and Soundness Act, a goal was set for federal secondary-market agencies to purchase at least 30% of their mortgages on housing units located in central city areas. Chapter 5 includes further discussion of this effort.

The Housing and Economic Recovery Act, or "HERA," enacted in July 2008, specifically addressed the subprime mortgage crisis. It authorized the Federal Housing Administration to guarantee up to $300 billion in new, 30-year, fixed-rate mortgages for subprime borrowers if lenders write-down (reduce) principal loan balances to 90 percent of current appraisal value. It also gave states the authority to refinance subprime loans using mortgage revenue bonds. HERA was passed with the intention of restoring confidence in Fannie Mae and Freddie Mac by strengthening regulations and injecting capital into the two large U.S. suppliers of mortgage funding. HERA did not achieve this aim, but it did establish the Federal Housing Finance Agency (FHFA) out of the Federal Housing Finance Board (FHFB), as well as the Office of Federal Housing Enterprise Oversight (OFHEO). The FHFA still has the oversight of Fannie Mae and Freddie Mac it gained when these institutions were put into conservatorship later in 2008. These two institutions remain in that status at this time.

Many primary market lenders must deal with the various risks associated with a business in which your ability to sell the mortgage loan you originate to an investor—without having to buy it back later if it fails to perform as underwritten—is commonplace. There are many moving parts to this process, which will be outlined in Chapters 4, 5, and 8. Events leading up to the financial crisis and subsequent mortgage meltdown share an interesting common theme: the lack of loan-level underwriting quality control. Recent Federal Housing Administration and enhanced GSE requirements for underwriting and quality control standards, as well as third-party business partner oversight, can no longer take a backseat to other regulatory matters. Legacy primary market originators need to break free of the daily struggle to find creative ways to source and fund loans in the secondary markets. They have become entangled in the legal battles that ensue from new court rulings almost daily as a result of lax quality control standards and lack of assurance that third-party originators are in compliance with underwriting standards and investor documentation requirements.

WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010

The financial crisis and resultant mortgage crisis brought about unparalleled foreclosures on home mortgages not seen since the Great Depression. Congress passed several pieces of legislation as a result of the crisis, including the Housing and Economic Recovery Act of 2008 and the Secure

and Fair Enforcement for Mortgage Licensing Act of 2008 (covered more fully in Chapter 4). These laws are intended to provide consumer protection against unethical mortgage practices. Sustained deterioration from the mortgage crisis of 2007 brought about continuous debate in Congress about the need for wide-ranging financial institution regulatory reform. Under strong public pressure, Congress passed the **Wall Street Reform and Consumer Protection Act** in 2010, also known as the "Dodd-Frank Act." Dodd-Frank ushered in some of the most momentous changes to financial regulation in the United States since the regulatory reform that followed the Great Depression. It made changes in the American financial regulatory environment of all federal financial regulatory agencies and virtually every segment of the financial services industry. The Dodd-Frank Act was intended to focus on the systemic risk that existed in the financial industry that seemed more obvious after the 2007 financial crisis. Prior to 2010, many consumer protection and mortgage banking regulations were enforced by one agency or another, and many were enforced and monitored by several different agencies covered. However, the problem existed due to the fact that noncompliance of one regulation can influence or jeopardize the performance of other requirements.

The mortgage banking industry today is large and varied, including a wide range of financial service firms. The volume of interrelated regulatory laws and governmental agencies has made mortgage banking one of the most highly regulated industries in history. With the passage of the Dodd-Frank Act, rulemaking authority was transferred to a new independent Bureau of the Federal Reserve System under the Treasury Department called the **Consumer Financial Protection Bureau** (CFPB) by seven different agencies for more than a dozen federal consumer financial protection laws. While many have been intimidated by these laws, be reminded that mortgage regulation compliance is crucial to sustainable home ownership and the need to correct the policy and systemic structural issues that gave rise to the mortgage crisis.

Dodd-Frank was passed to address several objectives:

1. *Regulatory gaps.* The Dodd-Frank Act grants power to a single regulator and charges it with the responsibility to mitigate the systemic risks within the system.
2. *Structural Concerns.* Dodd-Frank deals with additional structural issues now obvious. Large depositories and other nonbank financial institutions could be just as vulnerable to liquidity issues and bank runs not seen since the Great Depression.

3. *Liquidity Issues.* The act emphasizes the need to focus on liquidity concerns for large financial institutions caused by the inordinate amount of leverage used by those firms and increased concern over the regulation of "nonbank" activities, including payment, clearing, and settlement systems.
4. *Establishing the CFPB.* One of the purposes of the Dodd-Frank Act was to create the CFPB with a high level of autonomy over all consumer protection with little appeal from its decisions. Therefore, it takes full Congressional action to change any part of the Dodd-Frank Act; its funding comes from the Federal Reserve System (not Congress) and it is therefore more independent from lobbying by Congressional representatives forum-shopping for their constituents and lobbying from industry within Congress. The responsibilities of the CFPB were anticipated to include all the following:
   a. Conduct rule-making, supervision, and enforcement for federal consumer financial protection laws
   b. Restrict unfair, deceptive, or abusive acts or practices
   c. Take consumer complaints
   d. Promote financial education
   e. Research consumer behavior
   f. Monitor financial markets for new risks to consumers
   g. Enforce laws that outlaw discrimination and other unfair treatment in consumer finance

The CFPB has the power to enforce many of the consumer compliance and protection laws passed over the past five decades for consumer and mortgage credit. While the CFPB's regulatory authority extends to a wider span than just mortgage lending, this text covers only how the CFPB actions affect mortgage lending. Further discussion of changes made to the Truth in Lending Act and Real Estate Settlement Procedures Act, as well as other important changes in disclosure and compliance, will be more fully covered in Chapter 16.

LIFE INSURANCE COMPANIES

While **life insurance companies** are not considered depository institutions, they are fully regulated by the various states that charter them. There are no federally chartered insurance companies, although Congress

has explored the need for such from time to time. As new insurance companies have entered the health insurance and accident insurance business, an increase in consumer abuses has been noted. Further legislation is being examined at this time as their loan origination offices come under the provisions of the Secure and Fair Enforcement for Mortgage Licensing Act. However, in general, life insurance companies respond to older regulatory standards that have continued to offer sound protection for insured parties.

The cash that life insurance companies hold for investment comes from premium reserves and accumulated earnings. Because these reserves are not necessarily subject to demand withdrawal, life insurance companies have long favored the long-term nature of mortgage loans as investments. At one time, life insurance companies and savings associations held equal total investments in mortgage loans. But unlike savings associations, life insurance companies were not chartered for the purpose of providing mortgage money. Their primary interest in using their substantial investment funds is to provide the highest yield possible commensurate with the safety of their policyholders' money. This interest has dictated some flexibility in the movement of their investment funds from time to time to achieve better returns.

When a life insurance company sells an ordinary life policy or certain other kinds of life insurance, regulations normally require that a portion of the premium paid be set aside as a reserve to protect future obligations to the policyholder. The insurance company pays interest to the policyholder on the reserve amount (depending on the terms of the policy) and invests the money as it wishes—so long as it adheres to the regulatory limitations on investments of the state in which it is chartered. Over the years, this reserve pool has produced substantial returns for these companies while protecting the future payment of death benefits.

Casualty insurance companies—those that handle fire coverage, automobile insurance, and a host of other types of hazard insurance—have tremendous premium incomes but are not required to maintain the larger permanent reserves demanded of life insurance companies. Therefore, casualty companies hold their reserves in short-term investments due to the need for liquidity to pay claims. They negotiate practically no mortgage loans and we do not need to discuss them further.

In the United States, there are over 8,000 life insurance companies, including a few from Canada, selling policy contracts. These companies

range in size from a very few million dollars in assets to the multibillion-dollar giants that have become household names, such as New York Life, Prudential, AXA, and Metropolitan Life.

Investment Policies

Although insurance companies invest most of their reserves in high-grade securities, they also make mortgage loans. The larger companies have generally confined their real estate activity to making loans for large commercial ventures in which they can acquire a participating interest. Smaller companies follow a different path and often look upon individual home loans in their local communities as good business and a way to make contacts for the sale of life insurance. This kind of loan is intended for holding in the insurance company's own portfolio.

Regulation of Life Insurance Companies

All insurance companies are chartered and operate under the control of state regulatory authorities. Since there are no federal charters for life insurance companies, they adhere to policies that vary from state to state, but the regulations are generally directed toward protecting the policyholders. State regulations also apply to out-of-state charters doing business within the state.

State regulations usually set limits on the types of investment that are permissible; the percentage of total portfolio that may be kept in stock, bonds, or mortgage loans; and the amount of liquidity that must be maintained for each policy dollar outstanding. Most states establish limits on the maximum amount of any one loan, or for any one property. Some states have limited their own chartered insurance companies to investments within their own states, and others have placed limits on out-of-state companies selling insurance within their state unless proportional investments are made within the state.