APR 2

STATEMENT OF

MICHAEL PATRIARCA 11:45 AM

DEPUTY COMPTROLLER FOR MULTINATIONAL BANKING

OFFICE OF THE COMPTROLLER OF THE CURRENCY

BEFORE THE

SUBCOMMITTEE ON GENERAL OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

APRIL 16, 1985

I am pleased to provide the views of the Office of the Comptroller of the Currency (OCC) on the appropriate safeguards for financial institutions investing in mortgage backed securities. The OCC shares the Subcommittee's concerns about the potential for problems in the market for mortgage backed securities. Although we do not believe that the integrity or soundness of the banking system is threatened by the emergence of problems in this market, a thoughtful study of mortgage backed securities may serve to prevent serious problems in the future.

Financial institutions have long been a principal source of financing for the residential housing market. A substantial network of commercial and thrift lending institutions has provided financing for home purchasers on a nationwide basis. Traditionally, however, any particular geographic area was dependent on the availability of funds from its local lending institutions. This availability of housing finance, in turn, depended upon the depth of the capital and deposits of those local institutions.

The Secondary Market and Its Benefits

The secondary mortgage market has revolutionized housing finance. The process of pooling mortgages and using them to back securities in order to facilitate their resale.ensures virtually universal availability of housing finance. The secondary mortgage market permits institutions with available funds to diversify their portfolios with safe and liquid investments in mortgage instruments.

Conversely, small to middle-size banks and thrifts, whose available funds for mortgage lending may be quite limited, can nevertheless make home mortgage loans, pool them and sell them into the secondary market. Thus the secondary mortgage market, like other efficiently operating markets, moves the supply of lendable funds to areas where there is demand for home loans.

Although the operation of the secondary mortgage market has provided tangible benefits to originating and investing financial institutions, the major benefits have accrued to the home buying public. The development of this market has promoted a continued supply of long-term credit at affordable rates.

By virtue of its benefits to investors, mortgage originators, home buyers and their communities, the secondary mortgage market has grown significantly in recent years. According to the Mortgage Bankers Association, 60% of 1982's originations were sold in the secondary market, compared to some 30% throughout most of the seventies. By 1980, industry analysts estimate as much as three-fourths of all new home mortgages will be sold in the secondary market.

The significant growth in this market is likely to be even further bolstered by the enactment last October of the Secondary Mortgage Market Enhancement Act. Designed to encourage growth in mortgage backed securities issued by the private sector, the Act permits banks and thrifts to purchase unlimited amounts of mortgage related securities.

The Risks

Notwithstanding the overwhelming benefits associated with the mortgage backed securities market, there are risks associated with it as well. Mortgage backed securities are, after all, securities and share many of the same risks for investors as other types of securities, in addition to some unique risks. In order to make a prudent investment decision, investors must be able to assess the financial worth of the issuers and assets backing the securities. In the case of mortgage backed securities, at a minimum, an investor should know something about the properties serving as security for the mortgage, whether the appraisals on the properties and the collateral documentation are fair and accurate and whether these loans are originated and serviced by competent professionals. The investor must also know about the character and financial standing of the issuer of the securities, and the financial and legal position of any private company insuring the mortgages or acting as trustee.

For some mortgage backed securities, this information is readily available and reliable. If the securities are registered under the Securities Act of 1933, the issuer is required to provide audited financial and other information sufficient for investors to make fully informed and prudent investment decisions. Due to a variety of statutory provisions, however, many mortgage backed securities are exempt from the registration requirements of the Securities Act.

This exemption does not mean, however, that investors in these instruments must always fend for themselves in ferreting out the necessary information. Most publicly offered mortgage backed securities are subjected by their issuers to an independent assessment by a nationally recognized rating agency. These services provide professional assessment of the securities after examining all of the relevant background information. We feel that mortgage backed securities that are rated in one of the top two categories by a nationally recognized rating service are generally prudent investments for insured financial institutions.

However, in the absence of the registration requirements or the rating service process, we think it unlikely that many financial institutions will normally have the information necessary to make a prudent investment decision. Private placements of mortgage backed securities are typically exempt from the registration requirements of the Securities Act and do not normally have the benefit of a rating service analysis. Consequently, investors are left to their own devices in amassing information and making judgments concerning properties, appraisers, issuers, insurers, trustees and others that may be located diversely and remotely from the investor. Unsophisticated investors, particularly small depository institutions, in these circumstances are too often prone to rely upon the representations of issuers alone. Such dangers, coupled with the inherently limited liquidity of these privately placed securities, raise serious questions about whether such unregistered and unrated securities are appropriate investments for federally insured financial institutions.

Mitigating the Risks

At the Comptroller's Office, we are considering, among other things, the use of our rulemaking power to curtail investment by national banks in unregistered, unrated mortgage backed securities. While such investments may be appropriate for some investors, we doubt that they meet the standard of prudence expected of those institutions holding federal deposit insurance. Moreover, we do not feel that any such restriction on national banks will inhibit the continued healthy growth and development of the secondary mortgage market. In fact, by discouraging the inherently more risky securities in the market, the strength of investing institutions and of the market itself is likely to be enhanced.

Thank you. That concludes my prepared remarks. I'll be pleased to answer any questions you may have.