NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 272-2650

Remarks to
Board of Governors
Mortgage Bankers Association of America
Capital Hilton Hotel
Washington, D.C.
September 9, 1980

"PUBLIC CAPITAL FOR MORTGAGE CREDIT -
GIFT HORSE OR TROJAN HORSE?"

Stephen J. Friedman
Commissioner
Securities and Exchange Commission

I am sure that some of you find disquieting the mere fact that I am here tonight. What has the world come to when an SEC Commissioner and mortgage bankers find that it makes sense to sit down together and talk about regulating a sector of the mortgage credit markets! While you are right to beware of regulators bearing gifts, I hope I can convince you both of the inevitability of further financial and regulatory change, and the fact that these changes will be good for the markets in the long run.

You and I share the privilege of participating in one of the most exciting and innovative periods in American financial history. The dizzying pace of change recalls the ancient Chinese curse -- may you live in interesting times.

In my judgment, the changes in the mortgage credit markets have been largely a result of inflation. Steep and recurring interest rate cycles have changed the face of the thrift industry, exacerbated the cyclicality of mortgage credit flows, and transformed the basic financial instruments themselves. Most importantly, the enormous demand for housing has forced the major players to seek new sources of credit. In response, imaginative mortgage bankers, investment bankers and government officials have linked mortgage credit to the public long-term debt markets. That link has become a chain -- and nothing will ever be the same again -- not for you, and not for the SEC.

When the principal source of mortgage credit came from specialized thrift institutions required to maintain a major portion of their assets in residential mortgages -- and which were in turn protected in part from competition by Regulation Q -- there was a real sense that mortgage bankers functioned in a world separate from the conventional public markets. You were not competing directly with other bidders for long-term funds, a fact which provided a cushion against the effect of sudden changes in long-term rates. Your customers were institutions that were highly expert in the financial instruments in which they were investing. Securities firms were not involved. As a practical matter, mortgages presented little credit risk. They were either insured or protected by the steady increase in real estate values in the post-World War II period. Thus, without concerns about market stability, the danger of over-reaching investors, or credit risk there was no need for regulation.

What is the situation today? First, the universe of investors has changed drastically. Thrift institutions now account for only 25% of investors in Ginnie Mae securities. Today, there is a wide range of institutional ownership, including many less sophisticated institutions. Commercial banks, life insurance companies, and pension funds comprise the largest part of the investor group. And an increasing number of individuals are involved in Ginnie Mae trading.

Second, because the "action" in recent years has been in the bond markets, the number of professionals involved in mortgaged-backed securities has expanded beyond the old group of government securities dealers.

Third, the level of risk has changed drastically, both for investors and dealers. That shift is a function of both the sharp interest-rate movements that have characterized recent periods and the nature of the investments involved. Interest rate futures, Ginnie Mae forwards and standby commitments, as well as the new proposals for Ginnie Mae options, are all ways of transferring risks. They are profitable precisely because the risk is substantial. While small financial institutions may be expert enough to forecast interest rate movements for the purpose of asset and liability management, it is quite a different thing for them to devote a portion of their assets solely to assuming the risk element in fixed-income securities.

There is no question that problems have developed. In the Ginnie Mae area, the forward nature of the commitments and the lack of any mark-to-market requirements have created special risks. But the files of the Commission also show aggressive and abusive sales practices, undue risk assumed by financial institutions, inappropriate accounting practices to conceal the losses (such as adjusted trading), and a migration of some of the fringe elements from other areas of the securities industry into the Ginnie Mae market.

In effect, having stepped into the public securities markets, mortgage bankers are now riding a new horse. It shares many of the characteristics of the other horses that compete for public capital. There are many advantages in terms of the liquidity, breadth and efficiency of the markets. There are also disadvantages: a tight link to rapidly changing interest rates, a new set of investor concerns and, ultimately, perhaps a new regulatory framework. I hope you will not view this new horse as a Trojan horse, concealing an SEC out to impose great regulatory burdens.

There are two reasons why you should accept this change and help shape the regulatory environment in a sensible way: because you cannot turn back the clock on sources of mortgage credit, and because the purpose of securities regulation is to increase the efficiency, fairness and stability of the markets, not to interfere with them.

With respect to the first point, inflation will be with us, to one degree or another, for some time. The recurrent interest rate cycles of the '70's will not vanish by magic in the 1980's. Even the most diligent program to squeeze out inflationary excesses will take some significant time to produce results. With experiences like those of the last ten years, investor expectations will not change easily.

Along with the struggle to contain interest rates, the forces that pushed users of mortgage credit into the public markets will continue: the vulnerability of savings institutions to sharp interest-rate cycles, the fact that these cycles force savings institutions into non-mortgage investments, and the enormous demand for housing generated by the progress of the baby boom generation into their '30's, will all reinforce current trends in the 1980's. In reality, the use of specialized savings institutions forced you to compete for funds indirectly. While Regulation Q and the interest rate differential provided a cushion, it was overwhelmed by the pressure of interest rate movements. The ability to bid for the saver's dollar, denied to the banks, shifted to the money-market funds.

As a consequence of these trends, together with the high risk created by forward and standby obligations, many of the traditional concerns of the SEC in the market regulation area have become relevant to Ginnie Maes, particularly the protection of investors from improper sales practices and the importance of stable brokers and dealers to the general securities markets.

I think the SEC has shown an impressive ability to take a fresh look at old ways of doing things in response to change in the markets, and to fashion flexible and sensible solutions to exceedingly complex problems.

Our actions in building a system of regulation for municipal securities professionals is a good example of our willingness to adapt traditional approaches to new circumstances. Certain aspects of that system deserve to be recalled:

-- there is no issuer regulation

-- there is heavy emphasis on self-regulation

-- in those areas in which other agencies, such as the bank regulators, have a principal relationship with certain market participants, that relationship has been preserved in the inspection and enforcement areas

-- in order to promote consistency, the SEC has maintained responsibility for financial condition rules, for antifraud enforcement, and for reviewing rules adopted by the MSRB.

This general approach makes a lot of sense to me, and with appropriate adjustments, it is not one you should fear for Ginnie Mae securities.

In this age of antiregulation, there is something of a tendency to throw out the baby with the bath water. Regulation can serve an important purpose in promoting the market system. Granted our share of the excesses to which human beings are prone, I believe that the securities markets are better for our presence.

The SEC's general mandate is to increase the efficiency, stability and fairness of the markets. Although the protection of investors is the hallmark of our system, I do not view the securities laws as consumer legislation. Much of what we do has a separate public purpose -- preserving the critical role of the public markets in raising and allocating capital. The protection of investors is an essential element in maintaining the broad, liquid secondary markets that make effective primary markets possible. Liquid secondary markets will not exist if investors fear misinformation, fraud, manipulation or unstable intermediaries. While there have been relatively few scandals in the Ginnie Mae area, and they have involved only a thin slice of the industry, their impact on public perception is disproportionately great.

In a broader sense, it is our job to see to it that the public securities markets work properly. These goals are, it seems to me, as applicable to trading in Ginnie Mae mortgage-backed securities as they are to the general securities markets.

I would like to spend a few minutes talking about three aspects of regulation considered by the SEC-Treasury-Federal Reserve group that considered alternative patterns of regulation for the mortgage-backed securities market:

-- the participation of other agencies of government

-- self-regulation and investor protection

-- the stability of market participants

Joint Participation

As you know from newspaper reports, one option under consideration is giving oversight and certain rulemaking authority to a council composed of the SEC and other agencies. Such a structure would recognize the special interests of the Treasury and the Federal Reserve in securities backed by the credit of the United States. The management of the public debt is a critically important function, and the appropriate participation of other agencies of government makes a great deal of sense.

The joint council is, of course, only one structural solution to the desire to incorporate the views of the government agencies most concerned with the public debt. There may be other workable alternatives.

Self-Regulation and Investor Protection

The SEC has always valued the businessman's judgment on the best way to accomplish regulatory goals. We tend to tap that source more frequently as our regulatory responsibilities become more complex. Thus, we believe that it would be appropriate for a rulemaking body similar to the MSRB to have primary rulemaking authority over professionals in the forward markets for Ginnie Mae securities. This board could write rules in areas which the SEC has already indentified, based on its experience regulating broker-dealers in other markets, as necessary and appropriate. These areas include margin rules, fair practice standards, including suitability rules, and supervision and professional qualification requirements.

It is the lack of margin rules that creates the very high leverage in the forward market, and the lack of mark-to-market requirements that fuels the eternal optimism of investors. Together, they conspire to feed the very human capacity for self-delusion in investing. Changing this state of affairs would make a major difference.

It is also instructive to remember that unsuitable recommendations have figured prominently in SEC enforcement actions. And most of the regulatory agencies interviewed in connection with the joint study agreed that unsuitable recommendations have been a major cause of problems in the Ginnie Mae forward market. The SEC is particularly sensitive to the importance of the public perception that securities firms deal fairly with customers. Much of public investors' experience in the capital markets is colored by their relationship with broker-dealers. The investor -- even the institutional investor -- depends on securities professionals for good advice and suitable investments.

At the same time, it makes little sense simply to take the suitability rules developed for a broker's relationship with an individual investor and apply them wholesale to even unsophisticated financial institutions. Institutions are in the business of assessing interest rate movements. That assessment is part of the general task of asset and liability management, a task that is beyond the ken of most securities salesmen. Moreover, there are other government agencies with the primary responsibility of appraising the investments of depository institutions.

This is precisely the kind of situation in which self-regulation can be immensely valuable. Who is in a better position to articulate the appropriate standards of inquiry and behavior on the part of a securities salesman marketing a Ginnie Mae forward commitment than the responsible members of the community of Ginnie Mae dealers?

Market Stability

In addition to elimination of abusive practices in the Ginnie Mae market, we are concerned about preserving the financial integrity of securities firms. The tremendous dollar volume associated with the mortgage-backed securities markets raises serious questions about the potential impact of Ginnie Mae fails on the financial status of broker-dealers. In fact, these questions are not purely hypothetical. Registered as well as unregistered broker-dealers have suffered financial setbacks, some irreversible, due to highly leveraged positions in Ginnie Maes.

In many instances, brokers are simply middlemen in Ginnie Mae deals, matching buyers and sellers or running "matched books" on repos and reverse repos. Some investors, when faced with recognizing losses on Ginnie Mae forward trades, simply walk away from their commitments leaving brokers to pick up the pieces. The imposition of uniform margin and mark-to-market requirements on Ginnie Mae forward transactions could eliminate many of the financial problems for both customers and dealers caused by excessive leveraging and overspeculation.

I am not prescribing SEC regulation as a panacea for all the problems of the Ginnie Mae market. Obviously, the SEC cannot control interest rate swings or the general economic climate in which mortgage-backed securities trade. But, I would like to suggest that the SEC does have something of real benefit to offer to participants in the markets for mortgage credit -- a creative, responsive, and diligent presence which investors find reassuring, and which contributes to the efficiency, fairness and stability of the capital markets.