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Subject: Subprime Mortgage Lending

While the Proposed Statement on Subprime Mortgage Lending and its predecessor Expanded Guidance for Subprime Lending Programs are well-intentioned and necessary enhancement to institutions' prudential framework, their effectiveness is not only diluted but serve to undermine the competitive position of the domestic institutions supervised by the Agencies. In order to level the playing field and ensure all major participants active in this space are brought under a common prudential standard, which reduces systemic risk for the entire marketplace, the guideline should apply to the Consolidated Supervised Entities (and their affiliates) supervised by the SEC and the capital markets units of foreign universal banks active in the US (ie UBS, Barclays, CSFB, RBS, etc). It is curious to note a surge in the purchase of mortgage companies by the CSEs and foreign banks under the auspices of the implementing the "vertical integration" model, but a cynical observer may also come to the conclusion that the opportunity to compete without the shackles of more onerous regulation is just too good to pass up.

There are two principal camps contributing to the surge in mortgage products and loosening of lending standards across the industry: the originate & hold institutions through traditional commercial bank and S&L units (guidelines would apply), and unregulated &/or independent mortgage or finance companies who securitize most of originations with help of "Wall Street" (guidelines do not apply). The latter have only been able to thrive because they have been provided ample "secured" liquidity lines by the corporate & investment banking units of major US commercial banks and the capital markets units of the CSEs and universal banks whether in form of traditional warehouse lines, repos, conduits, total return swaps, etc. without adequate or significant regard to policing product underwriting guidelines of their de-facto counterparties, correspondents and/or agents/brokers. Nor do the rating agencies, underwriters and investors in the securitized product which aggregate and package these mortgage loans necessarily care to restrict or police whether guidelines applied by the sellers, so long as structural parameters of rating agencies satisfied and pricing passes the market. So a major swath of the marketlace could and would conceivably continue to operate outside the guidelines.

Would this proposed guidance possibly move more of such activity outside the purview of the Agencies? Again, likely, unless state licensing/banking departments of mortgage companies apply similar prudential and guidelines and review process. Even so, the possibility of a common standard across all the states is diminished. The Agencies, in terms of mitigating systemic risk, would again be mostly reliant on the safety & soundness principles applied by the providers of liquidity in the review and approval of such extensions of credit. Normally, such are only tightened when the problem has already hit (all players affected) and well on way to incurring significant losses. In most scenarios where significant losses incurred, the reaction by liquidity providers is usually extreme and contagious, which gives rise to other systemic issues (i.e., credit or liquidity squeeeze).

So this begs the question on whether market discipline best, whether achieved through rating agencies, GSE purchase rules (but not exit the market), MBS investors or the Agencies themselves through more targeted reviews of originate & hold institutions and providers of liquidity rather than a well-intentioned guidance that is at its core, anticompetitive, since not applied uniformly to all key participants.