H.R. ____, THE PRIVATE MORTGAGE MARKET INVESTMENT ACT, PART 1

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

NOVEMBER 3, 2011

Printed for the use of the Committee on Financial Services

Serial No. 112–82

U.S. GOVERNMENT PRINTING OFFICE

72–623 PDF WASHINGTON : 2012

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

SPENCER BACHUS, Alabama, *Chairman*

JEB HENSARLING, Texas, *Vice Chairman*
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
DONALD A. MANZULLO, Illinois
WALTER B. JONES, North Carolina
JUDY BIGGERT, Illinois
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
SCOTT GARRETT, New Jersey
RANDY NEUGEBAUER, Texas
PATRICK T. MCHENRY, North Carolina
JOHN CAMPBELL, California
MICHELE BACHMANN, Minnesota
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
STEVAN PEARCE, New Mexico
BILL POSEY, Florida
MICHAEL G. FITZPATRICK, Pennsylvania
LYNN A. WESTMORELAND, Georgia
BLAINE LUETKEMEYER, Missouri
BILL HUIZENGA, Michigan
SEAN P. DUFFY, Wisconsin
NAN A. S. HAYWORTH, New York
JAMES B. RENACCI, Ohio
ROBERT HURT, Virginia
ROBERT J. DOLD, Illinois
DAVID SCHWEIKERT, Arizona
MICHAEL G. GRIMM, New York
FRANCISCO "QUICO" CANSECO, Texas
STEVE STIVERS, Ohio
STEPHEN LEE FINCHER, Tennessee

BARNEY FRANK, Massachusetts, *Ranking Member*
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
GWEN MOORE, Wisconsin
KEITH ELLISON, Minnesota
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
ANDRÉ CARSON, Indiana
JAMES A. HIMES, Connecticut
GARY C. PETERS, Michigan
JOHN C. CARNEY, JR., Delaware

LARRY C. LAVENDER, *Chief of Staff*

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

SCOTT GARRETT, New Jersey, *Chairman*

DAVID SCHWEIKERT, Arizona, *Vice Chairman*
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
DONALD A. MANZULLO, Illinois
JUDY BIGGERT, Illinois
JEB HENSARLING, Texas
RANDY NEUGEBAUER, Texas
JOHN CAMPBELL, California
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
STEVAN PEARCE, New Mexico
BILL POSEY, Florida
MICHAEL G. FITZPATRICK, Pennsylvania
NAN A. S. HAYWORTH, New York
ROBERT HURT, Virginia
MICHAEL G. GRIMM, New York
STEVE STIVERS, Ohio
ROBERT J. DOLD, Illinois

MAXINE WATERS, California, *Ranking Member*
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
RUBÉN HINOJOSA, Texas
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
CAROLYN B. MALONEY, New York
GWEN MOORE, Wisconsin
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
ANDRÉ CARSON, Indiana
JAMES A. HIMES, Connecticut
GARY C. PETERS, Michigan
AL GREEN, Texas
KEITH ELLISON, Minnesota

CONTENTS

H.R. ______, THE PRIVATE MORTGAGE MARKET INVESTMENT ACT, PART 1

Thursday, November 3, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Schweikert, Royce, Manzullo, Biggert, Neugebauer, Campbell, McCotter, Pearce, Posey, Hayworth, Hurt, Grimm, Stivers, Dold; Waters, Sherman, Hinojosa, Miller of North Carolina, Maloney, Moore, Donnelly, Peters, and Green.

Ex officio present: Representative Frank.

Also present: Representatives Westmoreland and Renacci.

Chairman GARRETT. Good morning, everyone. I now call to order this hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises on the Private Mortgage Market Investment Act. We welcome everyone to this hearing today.

We will begin with opening statements, and I will yield myself 3 minutes to do so.

Today, the subcommittee is holding a hearing on the Private Mortgage Market Investment Act. The legislative text is a product of many discussions that we have had, both formally—like the subcommittee's recent hearing up in New York City—and informally, about the steps that need to be taken to bring private capital markets back to our Nation's secondary mortgage market.

Currently, the Federal Government is guaranteeing or insuring over 90 percent of the U.S. mortgage market. And everyone on both sides of the aisle and all market participants claim that they generally support the efforts to bring additional private capital back to the secondary mortgage market.

There are two things that must be done to have private capital begin to reenter this space. First, we must begin to roll back some of the government's involvement in the housing market. The subcommittee has already passed 14 bills so far this year with the intent of reducing the government's footprint and setting the course for the abolishment of Fannie Mae and Freddie Mac. This is a key and vital part of getting private capital going again, because as long as the cheaper government option is available, that will be the route that is chosen.

Second, we must take actions to facilitate increased investor interest in this secondary market by facilitating continued standardization and uniformity within the market, increasing transparency and disclosure, and providing legal certainties through a clear rule of law. If we do that, there will be robust investor participation in the housing market without exposing the American taxpayer to trillions of dollars of additional risk.

The legislation we are discussing today essentially sets up a new quasi-securitization market. The FHFA is tasked with establishing a number of categories, or mortgages, using traditional underwriting standards, that is, different levels of credit risk associated with each category. Also, the FHFA is responsible for creating standardized securitization agreements for this marketplace.

Each securitization agreement will standardize the servicing arrangements of the loans, process the loans, go through a modified representation of warranties, and provide the investors the ability to put back in quality loans. Securities that meet this specific underwriting guideline for a category and contain the standard agreements will be eligible for exemptions from SEC registration.

So this standardization and registration exemption will allow for a futures market as well in these qualified securities. And investors with varying credit risk appetites will then be able to buy these securities that meet these investment needs.

Next, the legislation also removes one of the biggest regulatory impediments to private capital re-emerging. It does so by striking risk retention provisions from the Dodd-Frank Act. I agree that risk retention has benefits and we have talked about that. The way this is currently being implemented will create multitudes of negative unintended consequences in the marketplace.

For one, I am not sure, really, when you think about it, what good the risk retention rule that we have right now will do if we exempt Fannie and Freddie and Ginny and loans with downpayments of 5 percent or more. That sounds like, if you consider it, just about every loan that is made out there.

Also, Fannie and Freddie had risk retention previously and we see where that got us. So I believe that a better form of risk retention is an improved standardized regs-and-warrant system that includes a structure that ensures investors' claims will be honored at the end of the day.

The legislation also provides a much-needed fix to the QM, the Qualified Mortgage definition created by the Dodd-Frank Act. We ensure that loans that need this text laid out by the statute are able to qualify for a true safe harbor, instead of remaining subject to unnecessary and burdensome legal liability. And to bring private investment back to our mortgage market, it is essential that the rule of law is clear, specific, and upheld. Investor rights and contracts must be honored.

So, by: first, facilitating the adjudication of disagreements between investors and issuers; and second, clarifying the rules around the first-lien holder's rights; and third, preventing government-forced loan modifications that would negatively impact investors, investors will finally have the certainty that they need to get back into the market.

Finally, in regards to transparency and disclosure, investors should be empowered, if you will, and enabled to do their own analysis of the assets underlying the securities that they are investing in. So by disclosing more detailed loan level data, while at the same time protecting the privacy of the borrowers, and by allowing more time for the investors to study that additional information, investors will be able to conduct more due diligence and lessen their reliance on rating agencies.

So that is a capsule, if you will, of what we are doing with this legislation. With regard to the Director's testimony that we are about to hear, and the ongoing work over at the FHFA, let me just say to you directly, I think that you are doing a very good job under very, very difficult circumstances. And I know that you have been called upon by some more extreme elements asking that you allow for Americans basically to pay for other Americans' mortgages.

I appreciate the positions that you have taken, because you sit here and as you stand in your positions, you are basically the last wall, if you will, protecting the taxpayers from literally billions and billions and billions of additional losses over these entities. I thank you for the work that you have done.

With that, I yield back.

And I yield 2 minutes to Mr. Miller.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

There is a lot to like in Mr. Garrett's bill. It is very similar to legislation that I have introduced in this Congress and in the previous Congress, as well: H.R. 1783, the Foreclosure Fraud and Homeowner Abuse Prevention Act of 2011. And the differences, for whatever reason, we have not yet worked across the aisle on this legislation, but I would certainly welcome the chance to.

It appears that the differences that we have are not deep philosophical differences. There is no partisan divide. We are trying to do the same thing in a somewhat different way. But it seems to be a practical difference, not a philosophical difference.

I certainly support the idea of standardizing contracts, like pooling and servicing agreements, making clearer and more transparent the underlying loan files and making sure that servicing standards are uniform. Those are all things that are in the bill that I have introduced.

I certainly welcome the idea of amending existing laws to make the mortgage security market function like other asset securities markets. That appears to be the—we appear to be trying to accomplish the same thing in this respect, but the bill under discussion today would really just create an entirely new mortgage market, a secondary mortgage market from scratch when there appears to be a clear model for doing it and grant great discretionary power to FHFA to fill in the blanks when there is a model that appears to work. Any grants in an agency that we originally thought would be an oversight agency—remarkable powers over an important part of our economy.

There are other provisions where the intent makes sense, but not exactly the way they go about it. I introduced legislation in the last Congress to prohibit servicers from being an affiliate from owning or any affiliate of the servicers owning secondary mortgages or second liens, where the servicers are servicing leans that are effectively owned by someone else, where the beneficial ownership is with someone else.

This bill prohibits any servicer from holding a second mortgage, which goes beyond that conflict of interest, and it is not clear why it should, why it would not make more sense simply to make the prohibition, which I welcome generally, only where the servicer actually does not own the mortgages that they are servicing.

It goes on. There are other issues where we are trying to get to the same place. We simply are taking different paths, but the paths are not incompatible at all. So I hope that there will be the opportunity to work on this issue across party lines.

Thank you very much. I yield back.

Chairman GARRETT. The gentleman yields back.

And I will just say that, absolutely, and especially on some of the points that you have raised, this is a draft version of legislation here, we are not wed to some of the provisions in here on that last point, which is a very complicated issue, and we look forward to—it is not only complicated, but divergent views on exactly how you actually get to the end of the day on that—so look forward to working with it.

The gentleman from Arizona, for 2 minutes.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

I would like to actually start this by thanking you, Mr. Demarco. You and your staff have, in many ways, almost been stunningly acceptable when we have had very technical questions, when we have just wanted to cut through some folklore. There are very few people in the bureaucracy I found here in Washington who will return a phone call that fast and be willing to be that detailed with it. So there is a great appreciation there.

As I have shared many times with the chairman and many of the members here, my personal fixation is the proper pricing of risk, because I believe that the failure to properly price risk is actually what has caused many of the cascades we see around us today. As I am being told, Freddie Mac lost another $6 billion last quarter. We are basically suffering through sins of the past, but sins of not pricing risk.

The other thing I do want to stand here and make clear is that I understand this was a draft bill. There are a lot of things in here I am excited about. There are a lot of things I am hoping as we hear testimonies we will ferret out and work through the details and the mechanics.

But the number of folks who come to my office, Mr. Chairman, and talk about risk retention, particularly in asset-backed credit cards, automobiles, all those other things, and many of those markets actually held up surprisingly well. Maybe we should not be going where we are going. Are we going to ultimately do more damage to the economy and the ability to finance our future?

And with that, Mr. Chairman, I yield back my time.

Chairman GARRETT. The gentleman yields back.

Mr. Peters, for 2 minutes.

Mr. PETERS. Thank you, Mr. Chairman, for holding this hearing.

I think we all agree that the American housing market is severely depressed, which, in turn, is holding back our entire economy. I believe that there is also widespread bipartisan appreciation for the fact that the existing GSE system is a failure.

Allowing Fannie and Freddie to pass on massive profits to their shareholders and huge bonuses to their executives and employees while sticking taxpayers with losses was a huge mistake and it should never be repeated.

However, given the importance of the housing industry to the larger economy, we need to make sure that we are moving forward with caution. Chairman Garrett's proposed legislation is a constructive and helpful addition to the ongoing debate throughout the future of housing finance reform. I think the bill attempts to replicate some of the things that the existing GSEs do right. It will provide transparency and standardization that will make it easier for investors to have confidence in the market for private label securities.

However, I am concerned that Chairman Garrett's bill does not do enough to ensure that 30-year fixed-rate mortgages are affordable to the middle class. We should not abandon the system that has, for decades, made the American dream of homeownership a reality for millions of middle-class Americans just because irresponsible lending exploited a weakness. In fact, I think we should work to eliminate that weakness while strengthening the system.

Representative Campbell and I have introduced legislation that would retain a limited role for government in the securitization markets to ensure that we would continue to have deep liquid secondary mortgage markets. My colleagues, Representative Miller and McCarthy, have also introduced bipartisan legislation on this topic, and I would hope as the subcommittee continues to debate these important issues, that those bills would also be given a full and thorough debate.

Mr. Chairman, I think it is very important that these bills come before the committee and are subject to a hearing, and I look forward to you scheduling such a hearing in the near future.

As a society, we value homeownership as a pathway to a better life. Therefore, it is appropriate that our country create opportunities so that we can extend the American dream beyond just the wealthiest Americans and ensure that owning a home remains affordable for the middle class. And I hope that we are able to accomplish that with this going forward.

I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back. Thank you very much.

Mrs. Biggert is recognized for 2 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman, and thank you for holding today's hearing on your proposal, a discussion draft entitled, "The Private Mortgage Market Investment Act."

In March, Treasury Secretary Geithner testified before our committee and said, "The administration and Congress have a responsibility to look forward, reconsider the role government has played in the past and work together to build a stronger and more balanced system of housing finance." I agree.

Today's draft is part of this committee's deliberative dialogue about how to stabilize the housing market, reduce taxpayers' liabilities, and facilitate a reentry of private sector capital for single-family and multiple-family housing. We have learned that, for private capital to assume an increased role in housing finance, investors need regulatory certainty, relief, and common sense.

What they don't need is rushed and unworkable rules like the QRM or unfair competition from Federal programs like Fannie Mae, Freddie Mac, or FHA. I look forward to today's discussion and yield back the balance of my time.

Chairman GARRETT. Mr. Frank is recognized for 6 minutes.

Mr. FRANK. Thank you, Mr. Chairman.

I would note that the ranking member is on her way—

Chairman GARRETT. Oh, the gentleman is recognized for 5 minutes; the remainder of the time.

Mr. FRANK. Yes, if the gentlewoman from California arrives, I will yield her part of that time; she may have been delayed. But I thank you for that.

I appreciated, Mr. Chairman, that you said to the gentleman from North Carolina that this was a draft bill. The reason I say that, and I would yield some time for an answer, is we have been informed that a markup on the subject of securitization was scheduled for November 15th. But I would think, consistent with your saying this is a draft bill, that would not be for this bill. I would yield if you would—is there an intention to mark up this bill on the 15th? I would think, you having said it was just a draft, that was probably not the case, but I wanted to clear up the confusion.

Chairman GARRETT. We are focused on this, on this bill. My comments with regard to the draft are just what we are talking about here.

Mr. FRANK. My question is, is that—there was a markup scheduled by the committee for the 15th, I believe, in the subcommittee on securitization. My question is, is this legislation the subject of that markup?

Chairman GARRETT. I don't have a date certain on any markups. If I could that I do that, I would, but I—

Mr. FRANK. I had a more specific—so that 15th date is not a markup date for this bill?

Chairman GARRETT. I do not have a definite markup date for this bill from the committee chairman—

Mr. FRANK. All right. I appreciate that, because then that clears it up, because we had been told there was a markup on the 15th on securitization, and there was an assumption it might be in this bill. But I take it from that now—

Chairman GARRETT. Yes, I have not gotten—

Mr. FRANK. Yes?

Chairman GARRETT. I have put requests in to try to move things along. Well, not request, but I want to move things along—

Mr. FRANK. I appreciate it, but the fact that you said it was a draft bill, I would think it would be unlikely. And I would also say, in light of this—and this is a very important topic, and I appreciate the tone so far, and I think we have some very important issues to grapple with. And I appreciate the kind of non-dogmatic tone of some of the testimony people recognize that there are questions here.

I think, Mr. Chairman, my recommendation would be that we probably would want at least another hearing on this. I noticed that we have one group of witnesses, and you don't want to get too many witnesses and bore the heck out of each other, but we don't have any direct lenders here. We don't have a—and I would ask unanimous consent to put into the record at this point a letter from the National Association of Home Builders (NAHB) expressing some doubts about this. The NAHB looks forward to working with the subcommittee to strengthen and improve the draft legislation but remains concerned that the larger reform effort currently under way would remove all Federal support of the Nation's mortgage market.

And it says that, while NAHB supports the objective of the draft bill, we look forward to contributing thoughtful recommendations to enhance provisions. We remain concerned about dismantling all government backing.

So I would assume at some point, we would want to hear from the home builders, the REALTORS®, and some of the direct lenders, as well as other groups that have an interest. And I would ask that this be put into the record.

Chairman GARRETT. Without objection, it is so ordered.

Mr. FRANK. And then I would also have some questions. I would say my major assumption of concern here is the repeal of securitization; I think risk retention; I think the ability to make loans and not have to stand behind them was a problem, and I think there was a—the proposal was to replace risk retention as an assurance here would affect with a fairly complicated set of regulations that would come from the FHFA classifying different mortgages.

My own view was that there was a—we would be better off with risk retention because that makes one government policy and then leaves it to the market, leaves it to the lender to decide. I think we have a fairly elaborate set of rules here. I noticed in Mr. Wallison's testimony that he had some questions about some of the specific restrictions that are put on who can do this and that.

Frankly, at first glance it seems to me the solution that is in the bill as an alternative to risk retention is excessively elaborate and relies too much on the decision of regulators and the judgment of regulators and not enough on a market incentive. And I think risk retention does that. It does impose the basic retention, but after that it is entirely up the market. And that is one of the ones that I would hope we would pursue.

And then the final question I have, Mr. Chairman, is where we stand in terms of housing finance legislation in general. We have 14 bills, I believe, that have been approved by the subcommittee. And we all know that in April, the Majority criticized us for delaying subcommittee deliberation by 1 day, and we have still not gotten to full committee.

So I guess would accept blame for 1 day's delay, and the Majority takes the blame for about 7 months delay. And I think other people are interested. We had the Hensarling bill that was offered as an amendment to financial reform and where there was criticism for not being included. That bill is off in limbo somewhere. It was reintroduced and has never been mentioned.

So I think there is a question. This is to replace the current GSEs, but I think there is interest in what the plans are for the

Majority to deal with the Hensarling amendment that abolishes Fannie and Freddie and the 14 bills, and maybe more to come, that make changes to Fannie and Freddie. I think it would be helpful if they at some point could be clarified.

Chairman GARRETT. The gentleman yields back. Mr. Dold is recognized for 2 minutes.

Mr. DOLD. Thank you, Mr. Chairman. Right now, through the GSEs, the taxpayers are effectively on the hook for over $5 trillion in total mortgage debt, and the GSEs are also responsible for nearly all new mortgages originated in this country since the financial crisis. And while taxpayers remain exposed to enormous and increasingly potential liability in our current financing system, our housing market remains severely challenged.

This situation is plainly unsustainable for both taxpayers and the housing market participants. Instead of a mortgage market dominated by the Federal Government and taxpayer guarantees, we need new and creative solutions that create the conditions for the private sector's return to our mortgage financing market without taxpayer guarantees.

To create those private sector conditions, we must have a legal framework that establishes and enforces uniform standards, transparency, and legal certainty for the private sector lenders and investors.

And I think Chairman Garrett's discussion draft, which we are considering today, goes a long ways towards creating those private sector conditions. So I want to thank the chairman for his work and his leadership on this important issue, and I certainly look forward to hearing from our witnesses today. I yield back.

Chairman GARRETT. We have just a minute-and-a-half left on our side. I will just claim a minute of that, and just to recoup where we are. So from one sense I get—some would suggest we are moving too quickly, and some other perspectives that some would argue that we are moving too slowly.

I guess in comparison to the way that Dodd-Frank moved, which moved through the committee actually without even many subcommittee hearings and not through regular order, I guess we are moving at the appropriate speed because we are doing this through the subcommittee process and we are doing it through hearings and what-have-you.

Comparatively, others say we are moving too quickly. We have had so far 17 hearings so far on housing finance. And the ranking member lists a number of organizations and groups and trade associations that would probably like to chime in on some of this legislation.

By and large, each and every one of us has been able to be at the table where Mr. DeMarco is right now and have had the opportunity during the course of those 17 hearings to answer the questions from either side of the aisle at any particular facet of housing finance.

Also, the question has been raised with regard to the other legislation that has been out there. Again, we have had 17 hearings for those pieces of legislation and others, the general topics of those to be discussed and to be questions raised to the members of the panel.

And I would suggest also that today, if anyone from either side of the aisle has questions on any other piece of legislation, Mr. DeMarco would be more than happy to discuss them, because he has already raised some of those points in his testimony.

I think time on both sides has expired. And with that, I will yield to our first witness, Mr. Edward J. DeMarco, Acting Director of the Federal Housing Finance Agency.

Again, I thank you very much for your work, and for your testimony today.

STATEMENT OF EDWARD J. DEMARCO, ACTING DIRECTOR, FEDERAL HOUSING FINANCE AGENCY

Mr. DEMARCO. Thank you. Chairman Garrett, and members of the subcommittee, thank you for having me here this morning.

I am pleased that the subcommittee is beginning the serious work of considering housing finance reform options which will lead to the ultimate resolution of the Enterprises Fannie Mae and Freddie Mac. My written statement provides a brief review of some of FHFA's work since I last appeared before you. I will focus now on the need for legislation.

Placing the Enterprises into conservatorship was designed to maintain market stability while providing lawmakers time to consider the appropriate course for housing finance reform and the transition from the current Enterprise structure. Conservatorship is not a long-term solution, yet we just passed the 3-year anniversary of conservatorship.

We all knew it was going to be difficult to develop a housing finance reform solution, but we must move forward on this process. As the conservatorships lengthen, FHFA must continually make decisions regarding investments in business platforms and human capital in the face of an uncertain future.

To state the obvious, the key question in the debate on housing finance reform is the future role of government. We should be clear about this question at the outset. It seems safe to say that there will always be some portion of the mortgage market that will be assisted by government programs.

In the future design of our housing finance system, careful consideration should be given to targeting subsidies to specific groups that lawmakers determine warrant that benefit. For example, the explicit government guarantees that the Federal Housing Administration and the Veterans Administration provide reflect policymakers' judgments as to the public benefits from targeting certain eligible borrowers with those problems.

Acknowledging that there will be a role for government, the next question is what type of structure is necessary to replace the activities that are currently undertaken by the Enterprises. There seems to be relatively broad agreement that the Government-Sponsored Enterprise model of the past where private sector companies were provided certain benefits and charged with achieving certain public policy goals did not work.

That model relied on investors providing funding for housing at preferential rates based on a perception of government support. This perception proved true, and the cost to the American taxpayers is now more than $170 billion.

In place of this system, the chairman's discussion draft would establish a functioning mortgage-backed securities market by replacing some of the standard-setting that the Enterprises provide today with a regulatory regime that sets those standards. This model would not rely on a government guarantee to attract funding to the mortgage market, but rather would look to standardization and rules for enforcing contracts to provide a degree of certainty to investors.

The process of undertaking housing finance reform is difficult. The discussion draft is a thoughtful approach to a framework that does not rely on a government guarantee. In the end, lawmakers must decide what structure will provide a functioning housing finance market that does not place taxpayers at risk.

Mr. Chairman, I would like to thank you for helping to move the housing finance reform discussion forward by offering your discussion draft and by holding this hearing. I believe that private capital markets can and should reclaim a prominent position in providing housing finance, and your draft proposal broadens the discussion of how that might be done.

I recognize this subcommittee and the full committee have difficult and important decisions to make in the coming months, and FHFA looks forward to offering technical assistance to both the Administration and Congress as a consideration of policy alternatives proceeds. Thank you.

[The prepared statement of Acting Director DeMarco can be found on page 66 of the appendix.]

Chairman GARRETT. With 50 seconds to spare. Thank you. So I will begin. I yield myself 5 minutes myself to begin the questioning. Thank you for your testimony.

Obviously, there is widespread disagreement from various factions with regard to what to do in general with regard to GSE and GSE reform, but I think there is pretty broad acceptance of the idea that we don't want to have a system—one of the terms you mentioned—with an implicit guarantee going forward.

So, you looked at our draft legislation. Basic question: Is there anything that you see in what you have before you that would create any implicit guarantee in this legislation?

Mr. DEMARCO. No, Mr. Chairman. Based on the review I have been able to undertake to date, I don't see how would one interpret or perceive an implied guarantee as a Federal taxpayer in the general framework that is outlined here. I believe it is pretty clear that this is putting investors on the hook for assessing and bearing mortgage credit risk.

Chairman GARRETT. Okay. That segues into actually the next couple of questions. What we try to do here is to create a system where the FHFA is able to go out and set up uniformity, homogeneity in the securitization side and then the underwriting side.

So let us just stop right there already and ask you if this were to occur, how do you see that playing out, if you will? How do you see those two aspects into fruition at the end of the day? And as to the point on the investors, what would you be doing to attract either a broad sector of investors interested in this or a narrower sector of investors in this?

Mr. DeMarco. I think that we would certainly be striving to have a deep, sufficient, and liquid mortgage market. And so, we would want to attract a broad set of investors to that.

I think that in the framework that your bill proposes, a key responsibility to FHFA would be in defining both the securitization structure and the classification of mortgages, that it be done in a way that allows for the market to reach that depth of liquidity and clarity about credit risk that would be necessary and appropriate to get efficient pricing of that credit risk by investors.

So I would envision that we would undertake doing this classification process in a way in which we were striving to achieve relatively deep pools of homogeneous mortgages, so that investors could have confidence, both in the forward market that would be created, and then in the execution in the secondary market. And investors could understand the risk characteristics of particular groups of mortgages.

Chairman Garrett. Just a side note there, you mentioned the forward market. And what would be the benefit of creating that liquidity in the forward market?

Mr. DeMarco. Sir, it allows investors to be able to make commitments for investing in mortgages before the pools themselves are actually structured. But in order for investors to do that, there needs to be pretty good clarity and certainty regarding the characteristics of the mortgages that are being committed to be delivered into the marketplace.

Chairman Garrett. But even further than that—okay, that is from the investor's side of the—

Mr. DeMarco. —from the borrower's standpoint, it allows the borrowers to commit and the lender to commit to a borrower a mortgage rate that can be locked in during the process of completing the transaction.

Chairman Garrett. And speaking hypothetically, if this were in place today, and I know it is not today, but the depth of the pools as far as what is being offered, how would you see that growing over time? We know what happened with regard to the CLL right now and where that is, but were that to change, how does that change as far as the depth of each of these pools, as far as what they—the interests of the investors in it?

Mr. DeMarco. Part of what is to be determined really in the marketplace in this framework is how these securities would be broken up and offered to investors that were looking for particular characteristics.

Chairman Garrett. Okay.

Mr. DeMarco. But look, we have an almost $11 trillion single-family-mortgage market. If you get several groups of classifications, I think there would be great deal of depth and liquidity that would emerge in the marketplace, given the size of the overall market.

Chairman Garrett. That is an interesting point. And some people have raised some questions about this as we went through. I have a couple of seconds left, and a point on that is that you need that depth and you need that liquidity for the trade to occur and in order for the rates to be there, regarding the issue of the 30-year fixed and the rest; correct?

Mr. DeMarco. That is right.

Chairman GARRETT. And so, in the statute we could have picked it to say it is going to be one or it is going to be 22 of these categories. But you are really saying, at this point in time, that is not a statutory provision that you want to do; right?

Mr. DEMARCO. I believe that is right. I believe that is sort of determined by getting feedback from investors and really from a whole set of stakeholders, so that we can get the most efficient grouping possible.

Chairman GARRETT. Great. I appreciate it.

I yield back.

The gentleman from Massachusetts is recognized.

Mr. FRANK. Thank you, Mr. Chairman.

First, I will acknowledge that you and I have very different definitions of the regular order you mentioned in the subcommittee. I will say if you look at the procedures with regard to the Financial Reform Bill, there were more hearings, markups, amendments, recorded votes, and Floor time than any other bill I can remember. But I don't believe it is regular order to have subcommittee consideration and then have 6 months go by and no committee consideration.

Regular order assumes a progression. We have 14 bills, some of which were marked up in April in subcommittee, and there has been no sign that any of them are going to go to the full committee. And there is a—this bill is premised on the situation when there is no more Fannie and Freddie, but this committee has the power to deal with that and hasn't moved on anything in that regard.

So I don't think, as I said, subcommittee alone is not regular order. That assumes a progression. We are getting late in the year, and I think the uncertainty is not helpful.

Beyond that, I have a couple of questions. Mr. DeMarco, I note you said the conservatorship was appropriate. And that came from this committee in 2007, 2008 working with Mr. Paulson.

One of the questions was, and the goal of course of the conservatorship, was to stop the bleeding to a great extent, and to try to preserve some function in the housing market without the losses that had preceded it. That essentially worked. I know that we don't want to keep the conservatorship ad infinitum and you don't want to be sentenced to a lifetime as the conservator. I appreciate that.

Mr. DEMARCO. That is a fact, sir.

Mr. FRANK. Has that essentially worked out? Would you say it is appropriate?

Mr. DEMARCO. Mr. Frank, I believe it has. I believe we have brought the stability to the marketplace so that mortgage finance continues to operate fairly effectively during the duration of the conservatorship.

Mr. FRANK. And I think you have done what we all can try to do and it is hard to do. And I give credit to Mr. Paulson and this committee, which did it. We worked together and with thanks to your predecessor and yourself. We always try in these things to be able to get the good things to happen and minimize the bad things.

Is it correct to say we sort of reached it? That is, as we look at the losses, and we can't be sure, it is only 3 years. But what is your estimate? What is the situation with the loans that have been made since conservatorship, or the purchases? What do you expect the loss rate to be with the post-conservatorship acquisitions, as opposed to the previous ones?

Mr. DEMARCO. I believe for both Enterprises, the post-conservatorships books of business will be profitable books of business—

Mr. FRANK. And I appreciate that. This committee did that in 2007, 2008.

Now, the next question is—you don't want to be the conservator forever, but somebody is going to be doing something forever if this bill passes: "The Director of the Federal Housing Finance Agency shall for purposes of this section prescribe classifications for mortgages having various degrees of credit risk rating from a classification of mortgages having literally no credit risk to a classification of mortgages having substantial credit risk, with the goals," etc. And then, it lists all these things. That is a pretty big job.

So this bill contemplates an FHFA in perpetuity, and it is a—the Director, I believe, read the bill. That is a pretty big job for the Director. What kind of staff do you think this would require? What kind of a permanent operation would we need to undertake the responsibility given to the Director of the FHFA under this bill?

Mr. DEMARCO. I certainly won't say that I have worked through that. The bill is pretty new here. But I would note that FHFA today has approximately 520 employees. We are still growing, but I would expect that we have quite an examination workforce in our current structure, because the current structure is focused on an immense undertaking in making soundness examinations of Fannie and Freddie.

This bill would replace that and there wouldn't be that function going forward. So as far as the size, I am not sure how much it would change. I think we would see a change in the direction and principal elements of work, from safety and soundness examinations, to assessing the mortgage market and establishing standards.

Mr. FRANK. So, all right, I think that is relevant. But people shouldn't think, apparently, if this package were to go through and we abolish Fannie and Freddie and adopt this, that we would substantially see it go away. And I must say, my own concern is that it is a very specific set of ongoing sort of government intervention in the market.

In addition to that, you would have to establish a variety of things. You would be described as mortgage default, delinquency, home documentation. And then you would do the standards servicing reporting, standards for modification. This is really a very significant government intervention in the mortgage market.

That is why I said my—and I am saying it—is we are told it is more efficient or better than risk retention. I think risk retention has a greater simplicity. And I am concerned about the capacity of any Federal agency to take on the degree of supervision of the mortgage market on an indefinite basis that this bill calls for.

I yield back.

Chairman GARRETT. The gentleman yields back.

The gentleman from Arizona?

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

Part of this is also a chance to ask a couple of questions. Could you walk me through some of the assets that the GSEs hold right now in performing paper, in impaired paper, in actually the number of properties that they hold title to?

Let us start there, because I have always been very curious if there are a number of assets there that would help you prime the pump, if they were sold without a guarantee, or—and just getting that pricing model? What would the market pay and what would the market absorb?

Mr. DEMARCO. Right, right. So in broad strokes, the two companies together have in order of magnitude $5 trillion worth of mortgages, single family and multi-family, that they either own and finance directly on their balance sheet, or that they provide guarantees to market investors. The financed portfolios of both companies are declining over time, and there is a minimum required shrinkage of those portfolios.

I don't know the exact number off the top of my head. Fannie Mae I think is on the order of a little over $700 billion right now, and Freddie Mac is in the $600 billion range. But those are shrinking over time. There is a change in the characteristic of that financed portfolio. It is moving less from whole loans in their own mortgage-backed securities, to being mortgages that have been purchased out of mortgage-backed securities, either for loan modification purposes, or because they are delinquent.

Mr. SCHWEIKERT. I thank this gentleman, Mr. Chairman, Mr. Demarco.

And so, just to make sure, let us take that $700—

Mr. DEMARCO. Billion.

Mr. SCHWEIKERT. —$700 billion. And those are ones where you hold the total paper?

Mr. DEMARCO. Where we own the total paper. So not only do we have the credit risk on them, but we also have the market risk of having to bundle them and hedge that market rate risk.

Mr. SCHWEIKERT. Oh, and then hedge that risk.

Mr. DEMARCO. And then, you asked about REO properties? These are properties that they have title to because the property has gone through foreclosure. Currently, the count for that is a bit less than 200,000 properties. It is in the 190,000-or-so properties.

Mr. SCHWEIKERT. Okay.

Mr. Chairman, Mr. DeMarco, has there ever been—and forgive me, but I saw some article on this, but this is something that I didn't follow up on—requesting pricing, saying, "Here is our portfolio of performing paper. Here is our impaired paper." What would you market? What would you pay as for parts of this, with a guarantee and without a guarantee?

Mr. DEMARCO. Yes, sir.

In September, I gave a speech in which I was sort of looking forward to the next things on the horizon for us as conservator, things that I think are appropriate, both to our conservator mandate and to preparing to attract more private capital back into the mortgage market to reduce the taxpayers' overall exposure.

And at the time, I talked about two things. The potential for, or my expectation that we would continue to see gradually increasing guarantee fees.

But the second, and this goes to your question, was that we would work on engaging more loss sharing with private capital for the mortgage activity, the new mortgage acquisitions Fannie and Freddie are doing. There are two broad ways that I outlined in my remarks that could be done.

One is to increase the depth of participation of private mortgage insurance companies providing insurance guarantees on mortgages. The other is that there are ways in the securitization process to break up pools of mortgages in a fashion you may sell a portion of the pool to mortgage investors, and do so without any Fannie or Freddie guarantee, and hence, without a taxpayer guarantee, and start to get a more true market price for the credit risk.

So these are options that we are exploring.

Mr. SCHWEIKERT. Mr. Chairman, Mr. DeMarco, any of that data coming in to you? Have you had anyone call you and say, "Hey, we would love to buy a few billion dollars and we will buy it without the guarantee, and here is what we are willing to pay on the yield?"

Mr. DEMARCO. We have certainly invited that with respect to the disposition of REO and got a lot of public interest. And I believe as we prepare to move in a more formal sense on the risk sharing, we will get those kind of offers.

I have informally had market participants suggest an openness to purchasing that sort of paper.

Mr. SCHWEIKERT. Okay. Mr. Chairman, down to the last 30 seconds.

Part of this—and I am very pleased with what you have been doing on the REO side. I am one of those who genuinely believes our real estate market will not come back in this country until we get these properties in people's hands, whether they are investors or first-time home buyers.

When you have a couple hundred thousand properties out there, we need to get those back into productive use.

Thank you, Mr. Chairman. My time has expired.

Chairman GARRETT. The gentleman yields back.

Mr. Miller is now recognized for 5 minutes.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

Mr. DeMarco, in my opening statement, I spoke of the conflicts or potential conflicts of holding seconds and then servicing firsts held by others, beneficially owned by others.

Do you see any—and I have asked the leading servicers, all of whom are affiliates, subsidiaries of the biggest banks, what business reason there was for that apparent, or at least that alignment of interests that are not identical which creates at least potential for conflicts.

And all I got was that there were cross-marketing opportunities, which seemed to be not a particularly persuasive reason. Do you see any reason to have that alignment of interest?

Mr. DEMARCO. I do, Mr. Miller. As a general proposition, I think one of the lessons to be taken from the last several years is the difficulties that second liens have posed for resolving problems with first liens.

And I think the potential conflicts of interest need to be identified, and how seconds that come in after firsts, altering really the risk characteristic of the first. All of these things need to be studied, and I think should be part of housing finance reform.

Mr. MILLER OF NORTH CAROLINA. Okay. When you began your answer, I thought you were disagreeing with me, but you were in fact agreeing with me. You do not see a reason to have servicers of mortgages beneficially owned by others holding seconds on those. There is no—

Mr. DEMARCO. I believe that is part of the conflict of interest. Whether there is another way of resolving that conflict by providing in law about what has to be done is another option. But as the way things stand now, I agree with you, sir.

Mr. MILLER OF NORTH CAROLINA. Do you not have the market power? Could you just not by contract require that? I have been frustrated at the enormous market power of Fannie and Freddie of holding half the mortgages—of legacy mortgages—and having almost complete monopoly power with respect to new mortgages and the unwillingness to use that market power. Not statutory power, not regulatory power, but just market power. Why have you not required that by contract?

Mr. DEMARCO. If the question is why I have not required by contract that second liens can't come in or restrictions on who may make those second liens, rather than put legal counsel on the spot, I am going to believe that is legally within my ambit. But I will say, Mr. Miller, that I will go back and we will study that question. If I am incorrect in my answer, I will report back to you.

Mr. MILLER OF NORTH CAROLINA. All right. And you and I have also discussed principal modification. And I have handed you, I think, a peer-reviewed economic study from the Federal Reserve Board of New York that shows that modifications that reduce principal lead to performing loans that reduce losses to mortgage holders.

And I, again—Fannie and Freddie have been unwilling to reduce principal. There is now a pending settlement that may in fact not go through of Bank of America and the Bank of New York Mellon.

And an essential part of that is that the investors in those mortgages are insisting that Bank of America give up servicing, kick out servicing where mortgages go into default to smaller servicers, higher-touch servicers, and that they reduce the principal to produce a mortgage that will not go through the hideous losses of foreclosure but is something that the homeowner can pay.

Have you talked with the folks at PIMCO, or at BlackRock, who seem to have come to a different conclusion about what is in their best interest?

Mr. DEMARCO. If I may pause for just a second, Mr. Miller. I wanted to check that my recollection was correct. Mr. Miller, my understanding of the proposed settlement agreement that you are referring to does not contain a mandate for principal forgiveness in it.

It does actually contain some requirements that Bank of America and any sub-servicer that would result from this would service these loans according to the standards actually that we have developed at FHFA in the form of our Servicing Alignment Initiative to promote loan modifications and those sorts of activities. I don't believe there is a mandate for principal forgiveness in there. But it does go to the servicing and the loss mitigation strategies we have.

Mr. MILLER OF NORTH CAROLINA. The former Mac program does have in the statute I think, certainly in the regulations, not just underwriting standards, which would be a really good thing that we make mortgages to people who can actually pay it back in the future. The other didn't work that well as a business model.

But it also sets out procedures for when a mortgage goes into default and provides for principal modification. Have you looked at how that program has worked and whether that works?

Mr. DEMARCO. I have not looked at that particular program; no, sir. I do understand that the chairman's bill would have part of what we would establish in terms of standards—would in fact be loss mitigation protocol. That would be part of the servicing standards that would be developed so that market investors would have certainty about how a servicer was expected to minimize the investor's loss in the event of a delinquency in the mortgage.

Chairman GARRETT. I thank the witness, and the gentleman yields back. And Mrs. Biggert is recognized.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Nice to see you here, Mr. DeMarco.

Mr. DEMARCO. Thank you.

Mrs. BIGGERT. Question, does Fannie Mae and Freddie Mac and FHA's dominance of the mortgage market allow for innovation in the private sector? We already heard about some of the businesses being shut down and jobs lost because they can't complete with the taxpayer-backed government programs like FHA. So should we continue to allow the government-sponsored housing programs to compete and edge out the private sector?

Mr. DEMARCO. To the first part with regard to innovation, I don't believe that the model of having Fannie Mae and Freddie Mac in conservatorship is one really conducive to innovating new products. In fact, as a conservator I have said we are not introducing new products.

So I think that the sort of market framework that would allow for innovation and introduction of new instruments and so forth would better happen outside of the realm we are in today.

Mrs. BIGGERT. Okay. Then, in the White Paper, Treasury's option one was a privatized system of housing finance with the government insurance role limited to the FHA, the USDA, and the Department of Veterans Affairs, assistance for narrowly targeted groups of borrowers. And that looks like a lot like the plan that Republicans have been promoting for a couple of years. And so, what is your view of option one?

Mr. DEMARCO. I believe option one that the Treasury Department put forward is certainly a credible option. I believe that Chairman Garrett's discussion draft is one of the first next developments, if you will, or refinements of Treasury's option one in that it provides a basic framework for Treasury's option one to be implemented legislatively.

Mrs. BIGGERT. Okay. Then do you do believe that if FHFA creates mortgage buckets and defines the standards to fit into those buckets, the private sector will perceive that the mortgages in the buckets are implicitly guaranteed by the U.S. Government?

Mr. DEMARCO. No. That is not how I understand it would work in this bill, and I don't see anything in the bill that should give that sort of assurance to investors.

Mrs. BIGGERT. I think that is always something that we are really working to make sure that we don't fall into maybe a trap like that again. And those are my questions. I yield back.

Chairman GARRETT. The gentlelady yields back.

Mr. Hinojosa is recognized for 5 minutes.

Mr. HINOJOSA. I am next?

Chairman GARRETT. You are.

Mr. HINOJOSA. Good. Thank you.

Chairman GARRETT. I am just looking past you at the same time and—

Mr. HINOJOSA. Thank you very much, Mr. Chairman.

Mr. DeMarco, how will the Private Mortgage Market Investment Act impact FHFA's ability to effectively regulate and be conservator of Fannie Mae and Freddie Mac?

Mr. DEMARCO. I would perceive this legislation as actually being in tandem with other legislation that has already been pending before the subcommittee and the full committee. I don't believe this is intended to be undertaken with an ongoing indefinite conservatorship of Fannie and Freddie. I believe this is framed to be a replacement. How that transition works, I believe remains to be worked out.

Mr. HINOJOSA. Does FHFA have the capacity and the expertise in-house to implement such a program that will go into effect no later than 6 months from the enactment?

Mr. DEMARCO. Interestingly, Congressman, there are a number of things that we would be required to do in this legislation that in fact we are already doing. The Servicing Alignment Initiative we have undertaken as conservator of Fannie and Freddie to establish more robust and consistent and effective mortgage servicing standards is something that we are already well along with and has already—the implementation of it has begun. That would be a key component of what would go into the standard setting that the chairman's discussion draft would have.

Mr. DEMARCO. The second thing is I have already made clear that as conservator of Fannie and Freddie, I am working towards changing their securitization process so that mortgage market investors would have detailed loan level data on the loans underlying a pool. This is also a provision that is part of the chairman's bill. This is something that we are working towards already.

So I believe that there are certain things that we have under way already, and we certainly have the expertise in-house to be able to develop that. So I think some of the work we are doing in our current role fits well with what is proposed in the new role.

Mr. HINOJOSA. What does the secondary mortgage market look like with no government guarantee on the long-term fixed-rate debt?

Mr. DEMARCO. The long-term fixed-rate mortgages, I believe, look like one that is pricing the risk according to what it actually is. You will get a true market price of the risk, not just the credit risk, but the interest-rate risk associated with a long-term fixed-rate asset by—the concept behind the grouping of mortgages is to give greater homogeneity in the securitization process so that investors would understand, this is a class M-type of pool, this is a class-P type of pool, this is a class-S type of pool.

And investors know what the key credit characteristic differences are between those different pools, and we would see that priced accordingly in the marketplace.

Mr. HINOJOSA. In listening to the dialogue that you had with my friend and colleague Congressman Miller regarding the principal modification, and your response was principal forgiveness. There is a heck of a lot of difference. And what we have been discussing here in our committee is that, if we are going to be able to make it possible for the person who buys the house for $300,000, and then it drops in market value to $200,000, they still have an indebtedness for some part of $300,000.

We are asking consideration of those modifications, and I need for you to give me some clarification because I am not clear on your response to Congressman Miller.

Mr. DEMARCO. I will apologize to Congressman Miller if I misunderstood his question, and hence didn't give an appropriate answer. But to your question, Congressman, about principal forgiveness, here is how I have looked at this as the conservator of Fannie Mae and Freddie Mac. I believe that we have an obligation to minimize taxpayer losses from the applicable business that they have. I also believe that we have an obligation. It is, in fact, in statute to be maximizing our efforts to avoid foreclosures, recognizing the net present value to the taxpayer. That is a statutory mandate that we have.

So what we are doing in the loss mitigation space with Fannie and Freddie is that there is a whole protocol that is in place at each company that the mortgage servicers are supposed to execute on their behalf. What this protocol is about is when a borrower goes delinquent on their mortgage, there is supposed to be immediate outreach to that borrower to find out what the reason for the mispayment is.

If the borrower is going to be incapable of continuing to make the full mortgage payment that they are obligated to, the first alternative we turn to is a loan modification appropriate for this borrower. The borrower committed to continuing to make a payment they can afford, and then they are committed to staying in the house. If so, that is the outcome we all want to see, and that is our first priority.

The way we go about that, the first step is, in fact, following the precepts of the Treasury Department's Home Affordable Modification Program, or HAMP. The HAMP program is designed to define what is an affordable payment. And it has been defined since the beginning as a payment that is equal to 31 percent of the borrower's monthly income. So the notion is 31 percent of income would go to pay the mortgage. So there will be a series of modifications made to the mortgage to get the borrower into a payment of that size.

We are, in fact, doing that, and Fannie Mae and Freddie Mac together have completed just under one million loan modifications. If the HAMP modification doesn't fit the borrower, they don't qualify, Fannie and Freddie each have proprietary modifications that will address the particular situations of the borrower. So that is—

Mr. HINOJOSA. I understand.

Mr. DEMARCO. —what we are doing. But principal forgiveness in that context, we have found we can get the borrower to that payment without doing principal forgiveness, and we better protect the taxpayer by preserving an upside potential if the borrower is successful in their modification.

Mr. HINOJOSA. I thank the gentleman for his answer.

Mr. DEMARCO. Thank you.

Chairman GARRETT. And I thank you. The gentleman yields back.

The gentleman from California is recognized for 5 minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman, and thank you, Mr. DeMarco.

As was discussed earlier, there is general agreement that the conservatorship was the right thing to do in 2008. There is also general agreement that the conservatorship and that the current system is not the permanent solution and that we need to replace it with something. I think the question before us here today is whether or not this bill is the sole and sufficient replacement for Fannie and Freddie as opposed to some of the other alternatives that are authored by other members of this committee, including myself.

So my first question for you would be, if Fannie and Freddie were to disappear tomorrow, and this bill were the sole replacement for that, is that sufficient? Could this PLMBS serve the entire marketplace?

Mr. DEMARCO. It could not do it tomorrow.

Mr. CAMPBELL. Why not?

Mr. DEMARCO. Because this would take some time for standards to be developed and articulated. And in order to attract private capital and to build out the infrastructure to do the securitization that is proposed in this bill, private capital is going to want to know what these standards are, what the securitization requirements are going to be, and then make the necessary and appropriate investments in infrastructure and in risk management to be able to execute it.

Over time, can that develop, and can that be implemented? If the market has certainty that these are the rules of the road, and if these rules of the road are not going to be changing every 3 months, I believe that the private market can step in and do a great portion of what is currently being done by Fannie and Freddie.

Mr. CAMPBELL. A great portion, I note. Okay.

Let us talk about what would happen, do you think, to FHA and the Federal Home Loan Banks—to the volume through them—if Fannie and Freddie were gone and this was the sole solution?

Mr. DEMARCO. FHA, even with Fannie Mae and Freddie Mac operating in conservatorship, really has an unprecedented volume today relative to any time in recent history. And I believe that for lawmakers, for you all to consider the housing finance system broadly, I would expect that consideration of FHA's role here, whether it expands, contracts, gets redefined as there are certain targets would be all part of what you all would figure out.

Mr. CAMPBELL. Because if you left it alone they would—a huge portion of the market would probably go through FHA if Fannie and Freddie disappeared and you just had this in its place, wouldn't you suspect?

Mr. DEMARCO. I wouldn't necessarily draw that conclusion, no.

Mr. CAMPBELL. If there were no changes, if they could—they used to be the lender of last resort, and now they have become the lender of first resort for many people, particularly anybody with less than 20 percent down.

Mr. DEMARCO. There are an awful lot of creditworthy borrowers out there who would, I believe, find market execution at an attractive price without having to go through FHA.

Mr. CAMPBELL. Okay. This bill actually has a lot of government restriction and control over the marketplace. And one of the things that requires FHFA to do is to promulgate underwriting standards. Could this not be construed as a stamp of approval by FHFA, and therefore have you opened to litigation or to legal liability from investors were those portfolios to go bad in the future?

Mr. DEMARCO. I believe that the discussion and careful review of the discussion draft on that point can and should continue. I would say, at first blush, it looks to me as though the bill is taking great pains to make clear that, in fact, is not permissible and that is not intended.

Mr. CAMPBELL. That it is not permissible to—because you are essentially filling—under this bill, as I figure—the role of the bond rating agencies.

Mr. DEMARCO. No, sir. I believe what we are doing is we are setting definitions and rules in terms of mortgages with this group of characteristics that will be classified as this class; rules with a different set of credit risk characteristics would be given this class title. And so, mortgage investors will know when an offering is made for this class, there is homogeneity about the risk characteristics. And then for this different class, there is homogeneity about the risk characteristics.

And the interesting thing about—

Mr. CAMPBELL. Can I stop you, sir, because my time is going to run out?

Mr. DEMARCO. Certainly.

Mr. CAMPBELL. I want to get to this last question. You are not just the Director of FHFA, but you are a noted economist. If the 30-year fixed-rate mortgage were to vanish as a result of this—no government guarantee because the private market doesn't want to accept the duration risk and the interest rate risk, etc., in addition to a credit risk—so if there were no 30-year fixed-rate mortgages, what effect would that have on housing prices? Because a lot of what we are talking about here is trying to keep—because if the housing market falls further, the economy will fall, and a lot of jobs will disappear, and that is what we don't want to have happen.

Mr. DEMARCO. Mr. Campbell, there is a predicate to the question I wouldn't necessarily agree with, that the implication is this bill would cause that to happen.

Mr. CAMPBELL. My question for you—

Mr. DEMARCO. But I understand. So the question is, if we suddenly outlawed 30-year fixed-rate mortgages, would there be an effect on house prices? There could be, but there could also be an effect on mortgage interest rates, which are also affecting house prices. And in some ways, this could—there are trade-offs there.

There are a lot of borrowers who don't use 30-year fixed-rate mortgages, and there are some borrowers for whom, in their particular circumstances, a 30-year fixed-rate mortgage is probably not the optimal instrument for them.

Chairman GARRETT. I thank the gentleman from California for his questions.

The gentlelady from California is recognized for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman. And let me thank Mr. DeMarco for his presence here today, and thank you for inviting him to come and testify on your draft legislation.

Title III of the discussion draft prevents Federal departments or agencies from engaging in forced principal write-downs. And I am not clear, looking at the bill, whether or not you are talking about a ban on principal write-downs as it applies to new loans or existing loans; however, and this is with respect to any securitized mortgage loan, you have stated, Mr. DeMarco, you said that given the calculations of FHFA, principal write-downs on Fannie Mae and Freddie Mac loans are not appropriate at this time.

Even though you have qualified that by saying "at this time", do you think that a statutory prohibition on principal write-downs is appropriate, or should the Director of FHFA have the flexibility to pursue principal write-down to future data demonstrate that it is appropriate?

The reason I ask this question is that—and it has been stated by my colleague, one of my colleagues—that many of us are very, very sympathetic to the homeowners who are underwater. And we really do believe principal write-downs make good sense. And we believe that principal write-downs will keep many of our homeowners in their homes, but for principal write-downs, they will end up perhaps being foreclosed on.

So my question, again, is what I already kind of stated: Should this be in law? Should we ban or prohibit principal write-downs in law or would you like to have some flexibility in dealing with this issue?

Mr. DEMARCO. At least with respect to the first part of the question, Ranking Member Waters, I believe it is equally legitimate for the Congress of the United States to legislate that the use of taxpayer funds to write down principal of other mortgages is an appropriate public policy and to provide for that. And I believe it is equally legitimate for the Congress of the United States to pass a law saying that is not an appropriate use of taxpayer money.

I really believe that is, at this point, a question for lawmakers. I have made clear, given my current responsibility as conservator with the source of funding that I have today, my view of why I am not doing it. But I believe it is really up to lawmakers to make that sort of determination because we are talking about the use of taxpayer funds. And I believe that rightfully fits as a determination of lawmakers.

Ms. WATERS. All right. Let me just segue to another issue that I have talked with you about, but I guess I am interested in the timing now. I am, and I think other members are very pleased, about the request for ideas that you put out relative to disposal of the 300,000 REOs that you have on the books. Could you tell us something about the timing of that? How fast is this going to move and when can we see requests for proposals go out?

Mr. DEMARCO. Right. So thank you for that. The subcommittee is aware that we recently made an important set of announcements regarding the HARP refinance program. I will say that the agency has been focused on that as the first priority. Now that work is just about complete, moving to this REO question and finalizing our review of these 4,000 submissions is our next priority. And I would hope to be at least making some positive movement forward over the next few months with that. I believe that we need to get going with it.

Ms. WATERS. Thank you very much. I yield back the balance of my time.

Chairman GARRETT. The gentlelady yields back.

The gentleman from Florida, Mr. Posey?

Mr. POSEY. Thank you, Mr. Chairman. Mr. DeMarco, first, I just want to say I applaud your written testimony, on page three where you say that you are going back and attempting to recover some compensatory damages. The question is, hopefully yes; or so, are any of the Federal law enforcement agencies working with you to recover some punitive damages?

Mr. DEMARCO. I can only speak to the actions that I have taken, Mr. Posey. So what we have done is we have undertaken the lawsuits that are public, the complaints that are public. I am not in a position to speak for law enforcement agencies of the government.

Mr. POSEY. So you are not aware that they are then?

Mr. DEMARCO. I can't speak for what law enforcement is doing, Mr. Posey.

Mr. POSEY. I am not asking you to speak for what they are doing. I am asking you if you are aware if they are working with you, behind you, beside you, if they are aware of what you are doing and have an interest in it?

Mr. DEMARCO. From time to time, sir, we are certainly approached by law enforcement about various things that they are reviewing and we always provide our full cooperation to law enforcement. So certainly, as a general matter, are there issues out there that law enforcement is pursuing in the mortgage area? The answer is yes. And we are providing our support to them when asked.

Mr. POSEY. Okay. Do you notify law enforcement when you discover fraud as you attempt to recover damages here?

Mr. DEMARCO. We have a mortgage fraud reporting regime at Fannie Mae and Freddie Mac. There is a great deal of reporting that is done. And they will oftentimes come back to us and ask for additional information or guidance—

Mr. POSEY. Thank you. I think last time, we heard that the defense fees for the Fannie and Freddie executives were in excess of $162 million. Can you give us an updated number now?

Mr. DEMARCO. Not off the top of my head. I would be happy to provide it in writing. I suspect given the pace of this, it has not changed much since my last appearance.

Mr. POSEY. I understand that since you were here, a court has ordered at least one of the executives to repay some bonuses that were apparently received and not deserved. Could that be viewed as any type of adjudication of guilt and maybe a reason for the American taxpayers to stop paying the defense fees for those crooks?

Mr. DEMARCO. Mr. Posey, I am not aware of the particular issue or circumstance that you just described. So I would have to find out exactly what ruling was made that you are referring to and then I have to assess that. I am not aware of, off the top of my head, the ruling you are talking about.

Mr. POSEY. Okay. I am going to make a couple of statements and ask you to tell me what is wrong with them. Number one, for about 60 years, we have had FHA loans, 3 percent downpayment loans, which require an extra 0.5 percent mortgage insurance premium. And to a large extent, the extra 0.5 percent mortgage insurance premium has paid enough through its accumulation for the losses that have been incurred through the loans. So basically, it is been a pretty good, sound system.

VA, which has no downpayment, only has a loss ratio of about 2.5 percent, which is incredible, because of the great job they do at underwriting and working with their clients. So, I think that is one argument for not reinventing the wheel. I will ask for your comments in a minute.

Number two, the mortgage bubble wasn't caused by mortgage limits or low downpayments. I would wager that at least three-quarters of the people in this room, if they follow the national trend, bought their home, at least their first home, on a 3-percent-down FHA loan and didn't default on it, as most people didn't. Most of the bubble and the crisis was caused by fraud enacted between the borrowers and lenders. And if we are to eliminate that fraud, the system should work without additional regulation, red tape and so forth.

Can you see anything patently wrong with those statements?

Mr. DEMARCO. I apologize. Certainly, mortgage fraud has been an important element of the debacle over the last several years, but I would not say that borrowers generally—let me set FHA aside.

FHA actually had a very small book of business during this peak period, but I believe highly leveraged acquisitions of houses with zero percent down or close to zero percent down in fact was very much a contributing factor to the housing bubble and to the loss the taxpayers have absorbed.

I would go further to your point about FHA and VA and say that these are certainly credible, explicitly government-guaranteed programs with targeted populations of eligible borrowers. And I believe it is every—I fully expect that wherever we end up in housing finance, we will continue to have robust FHA and VA programs.

And one of the decisions for lawmakers is in a post-Fannie Mae/Freddie Mac world whether there is consideration to be given in terms of altering in any way the program or eligibility of FHA or VA.

Mr. POSEY. Okay. I don't want to cut you off, but I am running out of time here on my 5 minutes.

Chairman GARRETT. Actually, you are over your time, so—

Mr. POSEY. Can I have just one quick follow up? Thank you, Mr. Chairman.

Chairman GARRETT. If there is—

Mr. POSEY. It has been my impression that Congress pushed Fannie and Freddie to make many of the loans that we now regret. And I hold Congress culpable for that. Do you think that is a fair assessment?

Mr. DEMARCO. I certainly think that Congress established certain circumstances that drove Fannie and Freddie, but I will not relieve the executives of those companies for making very poor and imprudent business decisions prior to conservatorship.

Mr. POSEY. Thank you.

Thank you very much, Mr. Chairman.

Chairman GARRETT. The gentleman now yields back.

The gentleman from California?

Mr. SHERMAN. We have recently seen some bonuses at Fannie and Freddie. I wonder if you have a comment on that.

Mr. DEMARCO. Yes, sir. I will say several things about the recent news. The first is that the compensation programs that are being reported about are the same compensation programs that have been in place since 2009, at the same levels that I have extensively testified about before Congress.

And I will say that a number of executives have turned over at the companies. We seek in every instance to be bringing in new executives at lower compensation than their predecessors. And finally, I believe that this compensation problem will be solved fastest when Congress gets on with coming to a final resolution of the conservatorships.

Mr. SHERMAN. This bill that we are talking about today is either a very small bill in its importance or a very large one. It is certainly useful to have standards of weights and measures for ounces and pounds. And it would be good to have federally-published standards for mortgage-backed securities. But this could be an enormous bill if it is somehow a step toward abolishing Fannie and Freddie and not replacing it with anything similar.

What does the secondary mortgage market look like to you if there is no government guarantee of long-term fixed-rate mortgages?

Mr. DEMARCO. As I said earlier in the hearing, I don't see the FHA or VA going away. So I believe there will in fact continue to be guarantees of 30-year fixed-rate mortgages. And I further believe that in the construct that is here, it would certainly be an opportunity for mortgage investors to price and to be willing to accept 30-year fixed-rate mortgages without a government guarantee.

Mr. SHERMAN. What does it look like if—to the average home buyer right now, if they have a qualified loan, conforming loan, they are paying a certain rate of interest. How much higher is that going to be without the government guarantee? I know what it was in my area 5 years ago before mortgage-backed securities got an ugly name, but what kind of increase are we going to see for somebody who is borrowing and not borrowing from FHA or VA?

Mr. DEMARCO. That is a fairly complicated question, because one needs to be more specific about the borrower. But I can make a general observation for you, Mr. Sherman, that I think would be helpful, which is that we continue to have a mortgage market that is outside the Fannie/Freddie realm.

And certainly looking, not just recently, but back at past history, suggests that we are on somewhat on the order of three-eighths to one-half of a percentage point greater on mortgage rates. But those borrowers also look like a different credit profile, it is not just—

Mr. SHERMAN. Same credit profile. Let us say we were talking about 75 basis points, what does it do to the value of homes in this country if for the vast majority of buyers, the interest rate is three-quarters of a point higher than it would be otherwise?

Mr. DEMARCO. I don't have an immediate answer for you on that, Mr. Sherman. Certainly, there is a connection between mortgage interest rates and house prices. And I would say that the incredible subsidization over a long period of time through Fannie and Freddie with affecting mortgage interest rates has been capitalized into the value of homes, inflating those values.

Mr. SHERMAN. Do you have any evidence or studies that would disagree with what I have seen, which would be another 15 percent to 20 percent decline in the value of homes?

Mr. DEMARCO. I don't have studies to point to with regard to value—

Mr. SHERMAN. Yes, you can. You don't have anything that would disagree with that and what does it do to the national economy if every—if the average home in this country declines by 15 or 20 percent over the next year as a result of action taken in this room?

Mr. DEMARCO. Obviously, a substantial decline in house prices would not be good for the economy or for the taxpayer. But we will see how this actually evolves, what sort of transition there is, and so forth.

Mr. SHERMAN. I yield back.

Chairman GARRETT. Thank you, the gentleman yields back.

The gentleman from New Mexico is recognized.

Mr. PEARCE. Thank you, Mr. Chairman.

Mr. DeMarco—nice to see you.

Just to kind of get the record straight, the last time you were here in committee, we had a little dust-up. And just to put it into the record, you came into the office and made a very professional presentation on the status of the institution. I appreciate that and still work from those notes. So thank you, and just to get that into the record.

Mr. DEMARCO. I appreciate it.

Mr. PEARCE. If we pursued just a little bit the line of questioning that Mr. Posey was on, what would be the definition of fraud? You were hesitant to say that a great percent of the loans are fraudulent. What would be the definition of fraud? And I will go ahead and give what I am thinking about.

I have been in discussion with one of the bottom-line lenders from Wall Street, and her performance bonuses were based on kicking loans out the door. You have to get them in, and kick them out. And she wouldn't compromise the standards. The other people sitting at the desks making loans were getting higher bonuses. Her supervisor gets bonuses if they get bonuses. And so, she is under pressure to make the loans. Would that be, in your estimation, fraudulent? Or it doesn't cross the ethical line, but it is up there?

Mr. DEMARCO. As you have described it, I would not perceive it to be fraud, as long as credit characteristics are being appropriately reported to the buyer or investor in the mortgage.

Mr. PEARCE. And I think where I am going with this is nowhere tricky, just any market is going to have that same pressure, whether it is this bill in front of us, or the market, frankly, that is operating toward you right now. It is a pressure that is going to be there. Is there any way to regulate that pressure? Is there any way to deal with it?

It is not technically fraud, but if there are mortgages out there that are not going to perform as well, and they are not categorized that way in order to get their bonuses, that is a problem in the system that I don't know how you get around, myself.

Mr. DEMARCO. Certainly, incentive compensation programs can be looked at as creating either positive or adverse incentives for how credit markets are functioning. So, incentive comp programs are pretty critical here, whether we are talking about executives or whether we are talking about rank-and-file employees.

But that the mortgage fraud issue generally can run quite a wide gamut of participants. It can involve appraisers. It can involve lenders. It can involve borrowers. It can involve companies that are actually pooling and securitizing mortgages. Fraud can occur at any number of places, including those.

Mr. PEARCE. If we can switch gears for just a second, a continuing drumbeat of concern that I have from the small banks in New Mexico is that if we go to some private market, they will never get the rates of return that they can in the large markets. And that they are suspicious of movement away from—they don't like the explicit guarantee, but the implicit guarantee.

What reassurance could we give people in New Mexico—the lenders—that they are going to be okay? That the private mortgage market will actually provide liquidity to them? Is that a reassurance that is possible, and is it one that is advisable to give?

Mr. DEMARCO. I think that is a great issue that concerns me a lot. I would answer it slightly differently. And that is, as we consider housing finance reform, whether it is the chairman's discussions, or after any other framework that is put forward.

One of the things that I would suggest policymakers and lawmakers alike should be assessing is: What does this framework offer to small and mid-size lenders, whether it is community banks, mortgage bankers, and so forth, to be able to be active participants in the mortgage market, so that we would have a more competitive marketplace; and one that it is not dominated, either at the mortgage origination point, or the mortgage servicing point—that it is not dominated by a handful of very, very large institutions?

Mr. PEARCE. Okay.

I yield back, Mr. Chairman.

Thank you for your response.

Chairman GARRETT. The gentleman yields back.

And before we go to Mrs. Maloney, just for the edification of the gentleman from California, the gentleman raised a good question with regard to the compensation issues and what needs to be done about that.

The gentleman is reminded that we had legislation, H.R. 1221, the Equity in Government Compensation Act—that was actually sponsored by the full chairman of this committee—which would basically try to address that and suspend the current compensation packages for employees of Fannie and Freddie and establish a compensation system that is consistent with the executive schedule, which I guess would be a lot less than was out there.

That passed the committee 27–6, I believe, however, the gentleman from California voted "no" on that piece of legislation. So just to set the record straight, we are trying to address that situation.

And with that, I yield to the gentlelady from New York.

Mrs. MALONEY. Thank you.

And welcome, Mr. DeMarco. We appreciate your comments on what is the 15th proposal this subcommittee has reviewed in the area of secondary mortgage markets this year.

I know that this question is not exactly on point with what we are reviewing today, but since you are here, I wanted to follow up on something I have been involved in with your office over the past several months. It concerns a recent story that was in the October 19th issue of the New York Times, entitled, "Rush to Drill for Natural Gas Creates Conflicts with Mortgages."

And it has raised important questions about how many of these new gas leases on private property in many States that do not have a history of such leases, and how this will impact on mortgages. The article reports that there are concerns that these leases do not ensure compliance with certain standards set by a secondary lending institution.

Earlier this year, I sent you and your staff questions on this area. And I appreciate your response. But your counsel's response raises question in light of the recent Times story. The piece showed there seem to be conflicts between these gas leases and mortgage rules, which could become a problem with investors who may want to get rid of their mortgage-backed securities.

And now that the technical defaults that these leases could create on mortgages, it may force Fannie or Freddie to buy these mortgages back. And if this happens, I assume it could be incredibly expensive for the U.S. taxpayers, since 90 percent of residential mortgages are owned by Freddie and Fannie. And so, many people have already signed these oil and gas leases.

So my question is, as the regulator, what is FHEA doing to audit the score of such a threat?

Mr. DEMARCO. Thank you, Mrs. Maloney. As you noted, my staff has been working with you and your staff to better understand this emerging issue and its implications, including its risks for Fannie and Freddie. And as you noted, we have provided one set of responses. With regard to the more recent development that you referred to, I will confess that I am not up to speed on that.

And if you would indulge me, I would be happy to get a more fulsome response and to get back with you in your office regarding this latest development, and to make sure that we provide a full answer to your question.

Mrs. MALONEY. Thank you. Your agency's letter said you were waiting to see what EPA determines about whether fracking is environmentally dangerous. And I believe that determination is irrelevant. Something does not have to be environmentally dangerous for it to negatively impact property values or violate mortgage rules.

Just take the example of a landfill. It is not considered dangerous, but it definitely lowers the value of property. Most people would not like a landfill in their backyard. And regardless of what EPA and the studies find, most research says that drilling negatively impacts property values, and as the Times' document showed clearly, drilling leases violate Fannie's and Freddie's rules.

So the question remains, if FHFA or Fannie or Freddie are going to do an audit to see how many mortgages across the country have non-compliant leases on them. This is a serious issue. It could cost billions going forward.

Mr. DEMARCO. So, Congresswoman Maloney, as I said, I will be very happy to go back and take a serious look at whether an audit is in order, whether that is feasible and practical, what it is we would expect to get out of it. I am sorry. I am just not prepared to do—

Mrs. MALONEY. Following up, are there any efforts in FHFA to see how many mortgages in the United States are overlaid with noncompliant leases? Is there any effort to look at that?

Mr. DEMARCO. I am being advised, Mrs. Maloney, that these leases which you are referring to may or may not be recorded. And so, our ability to be able to effectively gather this information is uncertain at the moment. But I am told that the staff is looking at this and will continue to, and I will be happy to follow up promptly with your office to advise you of where we stand.

Mrs. MALONEY. Thank you very much.

And my time has expired. Thank you.

Chairman GARRETT. And I thank you, gentlelady.

The gentleman from Texas?

Mr. NEUGEBAUER. Thank you, Mr. Chairman, for holding this hearing. And thank you for putting forth a very interesting proposal for bringing the private market back to mortgage finance. I think it is very important for the long-term stability of housing that we have a robust private financing market.

Mr. DeMarco, thanks for coming again. You have maybe what is one of the most difficult but most important jobs in our country right now. I guess the taxpayers and you got some bad news this morning. It looks like Freddie needs another infusion of about $6 billion.

What I found troubling about that was that they lost $6 billion in the previous quarter, but you are—if you go back a year ago, they only list $4.1 billion. And with the amount of origination that they have, you would have expected, I think, for the earnings to start showing some improvement. So I found that troubling. I would assume that you do as well.

Mr. DEMARCO. I certainly do, Congressman.

I would say that a portion of these—so the breakdown briefly, there are three key contributors to this. One is, an additional increment of credit losses is continuing to reflect both the pre-conservatorship book of business and difficulty certain housing markets are having in stabilizing.

It also reflects losses due to hedging in terms of a hedging of the financing risk of their retained portfolio, and then $1.6 billion of that is the dividend that is owed to the Treasury Department.

Mr. NEUGEBAUER. So recently, on September 30th, the loan limit temporary increase it was granted expired, and so the new loan limits are in place. Has anybody done an analysis of how much that would affect overall origination to the GSEs for that to move from the 729 down to the—what is it? The 625 number?

Mr. DEMARCO. I know we have how many mortgages, say, in the last year Fannie and Freddie had originated in that dollar range in the particular markets that were affected by the change in the loan limit. I am afraid I don't have that number with me, but I could easily provide it. It is really not a huge number, but we can get that for you.

Mr. NEUGEBAUER. In fact, it is a really small number. Would you agree with that—

Mr. DEMARCO. I would say certainly relative to their book, it is a very small number.

Mr. NEUGEBAUER. And so the question is—and Mr. Scott has a great proposal of bringing some certainty to the market—but what would be the incentive in the private market to originate anything in the current space that the GSEs are allowed to operate? What would be the incentive for the private market not to go ahead and let the Federal taxpayers guarantee that book of business long?

Mr. DEMARCO. It is pretty hard to compete with the Federal Government and the degree of support that is being provided right now.

Mr. NEUGEBAUER. So, if you are going to get the private sector back into the market, you are going to have to create some space for them to operate, because, really, there is no incentive below whether 625 for the private sector to originate anything that is not sent through the GSEs.

Mr. DEMARCO. Right. It is hard to compete with a government guarantee, and so as long as there is a wide footprint for that, that is going to be a wide space in the market that would be hard for private participants to compete in, in terms of their financing.

Mr. NEUGEBAUER. Do you think, though, that the fact that we did kind of create a little bit more space in the jumbo market by letting those limits expire gives us an opportunity to see; because, in fact, the private sector is operating in the jumbo space now. Isn't that a good opportunity, though, to create a little additional space without really giving up a lot of origination, because, as you just said, it is a very small amount of origination?

Mr. DEMARCO. It certainly is an opportunity to provide a modest amount of additional running room, if you will, for the jumbo market to be able to reestablish itself.

Mr. NEUGEBAUER. And so you would support that?

Mr. DEMARCO. I have remained faithfully agnostic on the question of what the loan limits should be, viewing that very much as a decision of lawmakers. But to your premise that, by having this well-announced in advance, gradual decline in loan limits in just certain areas, does that create greater opportunity for the private sector to reestablish itself, the answer, I would say, is certainly yes.

Mr. NEUGEBAUER. And so, here is a final question. I think recently we wrote you, and we would be anxious to hear your response, but with the fact that Freddie and Fannie, in certain spaces, basically have a monopoly on that origination space, what would be the reason to give certain originators different fees than others? Why would you have a spectrum there? You are not competing for the business; you are getting all of the business.

Mr. DEMARCO. Right. That is a very fair question. And I would say two things: one, in fact, those gaps have been declining; and two, I said publicly back in September that what remains in that space is something that I am looking to eliminate.

Mr. NEUGEBAUER. Thank you very much for your time.

Mr. DEMARCO. Thank you, sir.

Chairman GARRETT. The gentleman yields back.

And the gentlelady is recognized for 5 minutes.

Ms. MOORE. Thank you so much, Mr. Chairman.

And I do want to thank our guest for taking this time.

I just first want to mention that I am really happy to see that you have filed lawsuits against these 18 financial institutions to recover the losses suffered by Freddie and Fannie and to seek compensatory damages for the losses that the Enterprises have suffered.

There has been a lot of talk about the malfeasance, I guess, of Freddie and Fannie. But I think we too often forget that they were victims themselves of criminal activity. How much do you think you could recover from this, as compared to the exposure that Freddie and Fannie have?

Mr. DEMARCO. I appreciate the question, but I am afraid that is something, given that I am in litigation, that is really impossible for me to answer—

Ms. MOORE. Okay, thank you.

Mr. DEMARCO. We are seeking to recover appropriate—

Ms. MOORE. Okay, thank you. Right now, the FHFA is funded through the fees that the GSEs receive. You indicated earlier in your testimony that you need a considerable staffing-up in order to fill that TBA space. How would you—under this bill, how would you fund the GSEs?

Mr. DEMARCO. I am not sure that there would be GSEs, but in terms of the funding for FHFA, I believe it is—

Ms. MOORE. Right.

Mr. DEMARCO. —something that is not determined by—in this bill, and so that would be something that would have to be figured out.

Ms. MOORE. What—

Mr. DEMARCO. It is a gap right now.

Ms. MOORE. Is it a gap or a cavern? Is it a small gap, or is it a significant thing—

Mr. DEMARCO. For me, it is in fact—to manage this budget, it is a significant thing, since I want to know where the funds are coming from. But—

Ms. MOORE. How much does it cost right now to run it under—

Mr. DEMARCO. Our budget today is on the order of $180 million. So I am being told it is probably less than that.

Ms. MOORE. Okay.

Mr. DEMARCO. We are funded through assessments on Fannie and Freddie, but also assessments on the 12 Federal Home Loan Banks, because we have supervisory responsibility for them.

Ms. MOORE. Okay, thank you. Right now, the investors in Fannie and Freddie securities are basically rate investors. But under this bill, they would have to add credit risk as well as the rate. Is there any indication that we would be able to attract these kind of investors in a totally privatized market without the GSEs?

Mr. DEMARCO. That is quite right. We are in a rate market today because of the guarantees associated with Fannie and Freddie securities. What the pricing of this credit risk would be is going to depend on market appetite for credit risk, and then also with—it is also going to depend upon the clarity and resiliency of the standards and structures that are put in place.

Ms. MOORE. And so, what would a borrower, a mortgage borrower, have to look like? It would be totally risk adverse to these investors? What is the risk tolerance in order to be able to raise the appropriate amount of funds? If we want our mortgager market to come back, we have to be able to fund mortgage-backed securities.

What is your assessment of the tolerance for this credit risk in the private market only without a GSE?

Mr. DEMARCO. I believe that there is certainly tolerance to sort of the private capital to fund this risk. But they are going to want to know: "What are the rules of the road, and do I have pretty good clarity into how to assess the amount of risk that I would be undertaking?"

Ms. MOORE. Not NINJA loans, but what would be standard use, do you suspect?

Mr. DEMARCO. The standards in terms of the underwriting standards?

Ms. MOORE. Yes.

Mr. DEMARCO. Yes. Actually, as—the discussion draft would require us to—

Ms. MOORE. Would it be like 20 percent down?

Mr. DEMARCO. No, I don't understand the bill to require that sort of thing at all. I think the bill requires us to establish risk buckets, buckets of mortgages that are defined by their risk characteristics, and I would certainly—

Ms. MOORE. Okay. My time is about to expire, and you are not going to answer this question.

The largest mortgage insurer, the Mortgage Guarantee Insurance Corporation, is located in my district, the 4th Congressional District of Wisconsin. What impact do you think that this legislation would have on the mortgage insurance industry?

Mr. DEMARCO. I think that is an interesting question, because I believe that there are some investors who may well look to having various forms of credit enhancement either on mortgages or on pools of mortgages, and I think it certainly creates a market opportunity for private guarantors to replace what is currently a Federal guarantor.

Ms. MOORE. Thank you so much. My time has expired.

I yield back, Mr. Chairman.

Chairman GARRETT. The gentlelady yields back, and I appreciate the gentleman's answer.

And of course, the gentlelady knows that is one of the variables that may be considered by the FHFA as well.

Mr. McCotter is recognized for 5 minutes.

Mr. MCCOTTER. Thank you, Mr. Chairman. I would like to start by yielding 30 seconds to my colleague from New Mexico, Steven Pearce.

Mr. PEARCE. Thank you, gentleman, for yielding. Just in response to my good friend from the other side of the aisle who is talking about the negative impact of drilling on properties, if that was really the case, then you wouldn't have any properties in my hometown—we have gas wells in back yards, in the front yards; we have them on the school grounds. In fact, it positively impacts the values of homes in our town.

So when you are going to create a Fannie Mae dead zone if you limit loans to private residences in areas where they drill, so be careful in New Mexico. We don't mind out there. Thank you.

Mr. MCCOTTER. I am reclaiming my time. I have a question on economics and then a question about the past. The question is one our colleagues who talked about how the subsidizing of the Federal Government into the housing realm has helped to keep interest rates low, and that if all of a sudden, it went away, interest rates would climb back through the roof.

My question is, having a rudimentary understanding of the law of supply and demand, wouldn't it work that if the government subsidized the housing market purchases, that would mean they would be more available to more people? And the more people that there are for the limited number of houses, the higher the prices would go for those houses, which would then reduce the availability. Isn't that pretty much how that would work?

Mr. DEMARCO. In posing that sort of system in the short run, yes. And in the long run, you would see a change in the supply of housing.

Mr. MCCOTTER. And you would see the prices come down, which would upset the homeowners but not necessarily the people purchasing them, which would then make the actual downpayments—because 3 percent of the asking price of the house would be lower than it would be at the governmentally-inflated rate. I just wanted to make sure that I actually had read the book in college that some might have skipped through.

A practical question about the past would be, as you have stated, and I think everyone can see that in the operating of these entities, there were mistakes made by these boards and the people in charge of operating them. Is that a fair statement?

Mr. DEMARCO. Yes, sir.

Mr. MCCOTTER. And let me just say thank you very much for trying to go in there and fix it and working so well with us to do it. So this is not directed at you in any way. But just as a matter of curiosity, as well as public record, is there anywhere we can go and find just a very succinct list of who was on the boards and what bad decisions these boards made; because these people made a whole lot of money to screw this thing up?

And I think that under the concept of credit where credit is due, I know a lot of people who would like to thank them personally for their efforts.

Mr. DEMARCO. Since these were public companies, certainly in their annual disclosures and annual reports, the leadership of the companies is a matter of public record.

Mr. MCCOTTER. That is heartening. That is very heartening. I was also curious, since they are public companies, in those reports, is there anywhere we can find out how they managed to get these new jobs? These are important jobs.

These aren't just something that you would want to see go to a political crony who might not have the best of motivations or the best business acumen in terms of dealing with these things. So are those in there too? So you can say not only are these the people who should be credited with these decisions, this is also their compensation package, and here is how they were chosen to be on this board.

Mr. DEMARCO. I believe that is available information.

Mr. MCCOTTER. Can you send me the link and give me a nice little concise sheet of that so that I can share that with all the people in my district who are wondering why this thing got so bad so quickly, and people were compensated so much for so little?

Mr. DEMARCO. We can provide you information from the public record.

Mr. MCCOTTER. Thank you. I yield back.

Chairman GARRETT. The gentleman yields back. I appreciate the gentleman's question, and also learning about the book that he read in college, as well. But I used the footnotes. So I do appreciate, Mr. DeMarco, your being here today, and your candid and insightful answers to all of the questions.

And I believe that is the extent of the questions, although the record, as I always say at the end of the hearing, is open for an additional 30 days for additional questions. And as we go through this, I am sure there will be additional questions. Again, I thank you for your testimony and time today, and also your work as well. Thank you.

Mr. DEMARCO. Thank you so much, Mr. Chairman.

[Brief recess].

Chairman GARRETT. Greetings, and still good morning. We actually were able to complete the first panel while still in the morning before 12 o'clock, so we are glad that we have ample time now for hearing the testimony from the second panel. And we welcome all of you. I know we are going to get our last panelist here before he comes up to testify.

And so, we will begin with Mr. Deutsche from the American Securitization Forum. Welcome. Obviously, you are recognized for 5 minutes. Your full written statement will be made a part of the record, and we look forward to your testimony this morning.

STATEMENT OF TOM DEUTSCH, EXECUTIVE DIRECTOR, AMERICAN SECURITIZATION FORUM (ASF)

Mr. DEUTSCH. Thank you. Thank you very much, Chairman Garrett. My name is Tom Deutsch, and as the executive director of the American Securitization Forum, I very much appreciate the opportunity to testify here on behalf of the 330 ASF institutions which originate, structure, trade, service, invest, and serve as trustee for the preponderance of residential mortgage-backed securities created in the United States, including those backed entirely by private capital, as well as those guaranteed by public entities such as Fannie Mae, Freddie Mac, and Ginnie Mae.

Let me begin my remarks with what I believe to be a very clear consensus proposition. There is very strong political and economic will in the United States today to decrease the overall level of Federal Government involvement in housing finance, and to have more private capital eventually replace many of the risks and rewards of that involvement.

Given that 90-plus percent of mortgage loans made in America in the first half of 2011 were guaranteed by the GSEs, there certainly isn't a shortage of opportunity to achieve that goal. To date though, Fannie Mae and Freddie Mac have drawn $169 billion in direct support from the American taxpayer through the Department of the Treasury since they were placed under conservatorship, and are predicted by the FHFA to draw a total ranging from $220 billion to $311 billion by the end of 2014.

Given the substantial losses and the outsized role of the GSEs in today's U.S. mortgage finance system, the ASF's membership is strongly supportive of reducing the Federal Government and role in the mortgage finance system in America.

While there is little opportunity for an overnight transition, there is a strong need to begin that transition over time and work as soon as possible to restore the long-term health of both the U.S. mortgage finance system, the U.S. economy, and the U.S. housing market. Reducing dependence on the public guarantees for new mortgage origination necessarily implies that private capital has to flow again into the mortgage market.

Securitization is an absolutely essential funding mechanism for this to occur because bank portfolio lending will not be sufficient to meet overall consumer demand and reinvigorate the housing markets, particularly with the process of bank deleveraging and balance sheet reductions still under way, and with increased bank capital requirements on the horizon until Basel III.

This then begs the question of whether the U.S. mortgage market—that has grown up for nearly a century now around the presence of a government guarantee—can be broken down and rebuilt with investor demand without the backing of the American taxpayer.

Our recommendation is that Congress must begin incremental steps over a period of years to substantially reduce the government's role in mortgage finance. And we commend you, Chairman Garrett, for proposing today's legislation that works towards that goal.

Other key areas that may also help incrementally reduce the government involvement is Congressman Neugebauer's H.R. 1222, which will eventually, and over time, increase the guarantee fee, which will equilibrate the GSE competition with private market competition. The recent lowering of loan limits also creates more ability for the private sector to begin to reinvigorate and creates more opportunity for the market to return.

Finally, reducing or eliminating regulatory competitive advantages of the GSEs compared to the private label markets will also allow the private markets to better and on equal footing compete with the GSEs.

But before turning to efforts that may be helpful in resuscitating the private mortgage market, let me first highlight that the securitization industry is experiencing what our professionals may colloquially describe as a death by 1,000 cuts. If you look on the last page of my written testimony, it is attachment A—or I believe it is up on the monitor here—you will see a bit of a dizzying chart that briefly sums up the myriad of regulatory efforts that are currently under way impacting securitization.

Any one of these efforts may be appropriately benign in its own right, but when combined together in this great whole, they serve as an effective poison that will keep private mortgage securitization transactions from occurring in sufficient scale over time.

I think this is extremely deadly to the mortgage securitization market, particularly in an effort to try to reduce the public guarantees on mortgage transactions.

But because the GSEs are exempt from many of these rules, in particular such as the proposal to explicitly count the government guarantee as the 5 percent risk retention, these myriad new rules will further entrench the GSEs' artificial advantages over the markets rather than ratcheting it away.

Additional details on those issues may be found in our written testimony and various comment letters linked to in that testimony.

But turning back to your proposals, Chairman Garrett, the key area you attempt to replicate in the private market—the TBA market—certainly additional efforts to create standardization in this market will go a long way in creating more private market capital flowing into the mortgage finance market.

And particularly, as we have seen in the loan declines over the past month or so, we have seen private mortgage market originations replace what was formerly government guarantee.

And, in fact, if you evaluate the numbers on that, you evaluate Senator Menendez's proposal that came through the Senate, you will see that only approximately a $40-per-month increase in a $700,000 loan would occur because of those changes.

Ultimately, I don't think that is a massive or substantial increase in a private mortgage market over the government-guaranteed rate. So, ultimately, I do believe the private mortgage markets can substantially replace those roles. And over time, we look forward to working with the committee chairman to ultimately help that goal be achieved. Thank you.

[The prepared statement of Mr. Deutsch can be found on page 77 of the appendix.]

Chairman GARRETT. Thank you.

Mr. Hughes is recognized for 5 minutes.

STATEMENT OF MARTIN S. HUGHES, PRESIDENT AND CHIEF EXECUTIVE OFFICER, REDWOOD TRUST, INC.

Mr. HUGHES. Good afternoon, Chairman Garrett, and members of the subcommittee.

I am Marty Hughes, CEO of Redwood Trust, and I am honored to be here to testify today. Redwood has a long history as a sponsor and investor in private-label prime mortgage-backed securitizations, and we have done the only three newly issued private securitizations since the crisis began.

We hope to do a fourth securitization in the next couple of months. I thought, just as an interesting frame of reference, Redwood Trust has 75 employees and only 25 are dedicated to this effort. So it can be done.

My testimony is focused on the Private Mortgage Investment Act. But before I move to the main part of my testimony, I would like to address the ongoing government subsidies for the mortgage market.

As I discussed in my previous testimony, government subsidies must be scaled back on a safe and measured basis to reduce and create a level playing field for the private markets to flourish. Despite the warning sounds from some, mortgages did not become instantly unaffordable to thousands of prospective home buyers when the limits were reduced on October 1st.

We saw a smooth transition in the market to the new low conforming loan limits and, in fact, through the month of October, the difference in interest rates was less than half a point between the non-conforming and the conforming rate.

I urge the committee to reject the attempts to raise the loan limits back up, as some have suggested, and give the private market additional opportunity to return to a sustainable state.

Directing my attention specifically to the proposed legislation, we are just going to highlight a few things. And, overall, I would like to thank you for addressing the overall topic. It is the first omnibus bill that is going in to address all the different elements from servicing that are really investor concerns.

My first comment is about second liens, which is one of Redwood's major concerns, and a big concern of the investors in our securitizations. And we believe the steps taken in the bill are a good first step, but we think you need an additional step.

The most important part of skin in the game is at the borrower level. If the borrower can remove their skin in the game after the first mortgage is given out, the likelihood of default on the first goes up significantly.

This was a significant event in the crisis that led to losses. And it continues to be a significant event that keeps investors out of the market. They can do their loan-to-value analysis on day one, knowing what the amount of the first mortgage is. They can't do analysis later on and catch up if all of a sudden, the credit profile of that borrower has changed.

In terms of representations and warranties, incorporating mandatory arbitration, we think is great. We have incorporated it in all three of our deals. We haven't had to use it yet.

One other thought that we have in terms of the proposed legislation is the concept of having a third party identify all claims, and let them be the one independent party to push through reps and warranties.

In our deals, we are the credit risk manager, as holding the lower tranches of securities.

So maybe the best protection for the higher tranches of securities is that the people on the bottom who were first in line to absorb losses are the ones to fight claims. Because our concern is, with an independent third party, there is not nearly as much incentive as there is for somebody at Redwood to fight claims for the protection of the senior lenders.

If we turn our attention to servicers, prospective surveillance standards should be developed to govern when a trustee must investigate a servicer's performance. There need to be defined events that require when actions need to be taken, whether it is excessive loan losses, modifications, or early-pay defaults.

While we fully agree that servicers need to be accountable, we think the removal of the servicer and the transfer of the servicing is a difficult and time-consuming process; and probably very difficult for borrowers if they are in the middle of some type of loss mitigation.

Really, what we think would make sense is to have the servicers have a "hot backup," a special servicer that would work behind them, that is already in place. They would have the systems, the contact points, and it would be an easy transition to go from the primary servicer to the special servicer.

So, in conclusion, I thank you for putting this bill forward. This bill is really important. There are a lot of facets to it. We do have some questions about some aspects, but we really applaud the efforts in moving it ahead. And thank you for beginning the process.

[The prepared statement of Mr. Hughes can be found on page 116 of the appendix.]

Chairman GARRETT. And thanks for your testimony. It raises more questions, but that is what we are here for.

Ms. Ratcliffe is recognized for 5 minutes.

STATEMENT OF JANNEKE RATCLIFFE, SENIOR FELLOW, CENTER FOR AMERICAN PROGRESS ACTION FUND; AND EXECUTIVE DIRECTOR, CENTER FOR COMMUNITY CAPITAL, UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL

Ms. RATCLIFFE. Good afternoon, Chairman Garrett, and members of the subcommittee.

I am Janneke Ratcliffe, senior fellow at the Center for American Progress Action Fund and executive director of the UNC Center for Community Capital. Thank you for the opportunity to comment on the draft Private Mortgage Market Investment Act, which addresses several challenges that must be overcome to restore a well-functioning system of housing finance in America.

I am also a member of the Mortgage Finance Working Group, authors of a plan for responsible housing mortgage market reform. And though I speak only for myself today, my testimony does draw on our plan.

Our proposal calls for private capital at risk to play a much greater role in the market than it does today. For that to happen, investor confidence in non-guaranteed securities must be restored. And this bill lays out several steps that will be helpful to that end.

Importantly, the bill recognizes that the Federal Government is critical to a well-functioning market, even the purely private part. Thoughtful oversight, implemented a decade ago, could have staved off much of the bubble and bust of the mid-2000s. And I am pleased to see the regulation of private mortgage-backed securities getting the congressional attention it deserves.

Issues detailed in my written testimony that I will highlight are as follows: first, Congress should take steps to restore investor confidence so GSEs can stop serving borrowers who don't need them.

But some government role in ensuring liquidity and access remains absolutely critical for the bulk of the $11 trillion mortgage market. It would be unwise to pull the rug out from under the market by scaling back this support too quickly.

As the draft bill suggests, standardization of products, terms and conditions is critical, and I particularly commend the proposal for demarking the 30-year fixed-rate mortgage category, which has been the building block of middle-class economic security in this country for more than 70 years.

And I concur with Mr. Peters' prior comments on the need to take additional steps to ensure it continues to be broadly available. Classifications of mortgage loans as called for in this bill should consider loan and channel factors that have been proven to affect risk. And though it is unclear how the categories will be set, is clear it will be a challenge to get it right.

There is real risk that if the classification system is based on borrower factors, it could duplicate problems raised by the recent regulatory proposed QRM definition. Moreover, we must avoid repeating the mistake of consigning qualified borrowers with fewer resources to higher risks, higher costs, products, and channels.

To Mr. Posey's earlier point, my written testimony provides evidence of additional sustainable high loan-to-value lending to moderate-income families that has proven successful, even during this time of market turmoil, and I would be glad to provide more details during discussion.

The bill's transparency requirements and loan level disclosures are welcome changes to the PLS market. One open question is whether those standardization measures will go far enough to foster a private label TBA market.

In the proposed private market, multiple loan classes, multiple issuers, and a lack of government guarantee may likely inhibit a TBA market, making this regime a useful complement, but necessarily a viable substitute to serve the entire conforming loan market.

The bill's measures to reduce conflicts of interest related to second liens are also welcomed. However, any provisions that limit the use of second liens should be constructed to favor legitimate downpayment assistance programs, which are so vital in so many communities' economic recovery at this time, and allow households to make productive use of their accumulated housing wealth.

There are certain provisions of the draft that should be reconsidered altogether. These include striking risk retention requirements, standing government principal reduction initiatives, and easing qualifying mortgage rules.

Other fundamental questions to be addressed include choosing the best regulator to fill the mandate, how the bill fits in with active GSE reform proposals, and other critical next steps toward a more responsible and comprehensive system of housing finance. Standardization and transparency as promoted by this draft bill are essential, but are not enough.

A well-functioning mortgage market also requires broad and constant liquidity, stability, affordability, and consumer protection. In closing, I would like to commend the chairman and the other members of the committee for holding this hearing.

As Congress and the Administration work to design a better system of housing finance, it is important to make sure the rules of the game are laid out clearly and fairly before anyone can be expected to start playing.

I believe the Private Mortgage Market Investment Act as drafted is a helpful starting point for negotiating those rules. But it must be seen as only a first step towards comprehensive reform. And I look forward to your questions.

[The prepared statement of Ms. Ratcliffe can be found on page 124 of the appendix.]

Chairman GARRETT. Thank you.

Mr. Wallison, welcome back. You are recognized for 5 minutes.

STATEMENT OF PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE (AEI)

Mr. WALLISON. Thank you, Mr. Chairman.

My name is Peter Wallison. I am a senior fellow at the American Enterprise Institute, and I would like to make the following oral statement. I have also submitted a detailed written statement. There are three serious problems facing this country: unemployment; the Nation's enormous debt; and the deplorable state of the housing market.

All three are directly involved in the subject of today's hearing. The proponents of a government role in the housing finance system don't mention it, but continuing the government's role in housing finance increases the Nation's debt. There are $7.5 trillion of government agency debt, most of it Fannie's and Freddie's that is off budget, but still a burden to the taxpayers.

We can reduce it by eliminating the GSEs over time and turning over housing finance to the private sector, like every other part of our economy. Securitization, which has worked well for 30 years and is almost universally used for credit cards and auto loans quite effectively, is a necessary source of funds for mortgages. This is because there are insufficient funds in the banking system to meet the housing sector's needs.

And banks have to raise capital levels, which causes them now to reduce their lending. Securitization also accesses a huge, currently untapped source of funds. Fixed-income investors, such as insurance companies and pension funds, have at least $13 trillion to invest and almost all of it now goes to corporates, some of it to junk bonds. Institutional investors used to be major buyers of mortgages, but not after the GSEs came to dominate the field.

The yields on GSE securities are just too low for the needs of these investors. Mortgages would diversify their risks, making them much more stable. It also provides funds for U.S. homeowners, a win-win situation if there ever was. A robust securitization market will bring in these institutional investors, and of course, if the housing market revives with more funding, unemployment will decline.

Since the financial crisis of 2008, private mortgage securitization has almost been moribund. One of the major reasons is uncertainty about the government's future role in the housing market, for example, whether Fannie and Freddie will continue to exist or some other government program will replace them. Few if any firms are going to invest in a securitization program if they understand or believe that they will be competing ultimately with the government.

Beyond that, however, various provisions of the Dodd-Frank Act add substantially to the risks faced by securitizers. These are detailed in my prepared testimony, but I will name a few now. The 5 percent risk retention idea gives a huge financial advantage to FHA and the GSEs. They can securitize any mortgage that is not a QRM without paying the large capital costs of holding a 5 percent risk slice indefinitely.

Private mortgage securitizers simply can't compete with this. Anyway, the whole 5 percent retention idea doesn't work to reduce risk-taking, only a vertical slice through the pool will qualify for true sale treatment under accounting rules, and the vertical slice does not provide much incentive to avoid risk taking.

Fortunately, the Garrett bill will repeal the risk retention provisions of the Dodd-Frank Act and substitute a more effective means for preventing deterioration of underwriting standards. By providing for minimum mortgage standards and securitization, it reassures investors and prevents the kind of mortgage meltdown that caused the financial crisis in 2008.

The bill also goes some distance toward eliminating the nuclear bomb lodged in the QM provisions of Dodd-Frank. This creates a defense to foreclosure if a borrower claims that he received a mortgage he could not afford. The bill exempts prime mortgages from this provision and also provides for an exemption from the Securities Act for qualified securities based on prime loans. Other provisions require the standardization of documentation used in securitizations, including trust and servicing agreements, mandatory arbitration, and appointment of an independent trustee when a servicer has a conflict of interest with investors.

All these provisions will encourage firms to enter the securitization business and institutional investors to buy and hold the resulting securities. There are many more reforms that I haven't mentioned. Many of them are necessary, but not included in the bill. This legislation is an important start on the process of reviving the private mortgage market, controlling the U.S. debt, creating a growing housing market, and reducing unemployment.

That concludes my testimony. Thank you.

[The prepared statement of Mr. Wallison can be found on page 142 of the appendix.]

Chairman GARRETT. I thank the entire panel for all their testimony. I will now recognize myself for 5 minutes for some questions. Mr. Wallison, I think if I heard him right at the very beginning, the ranking member said that legislation would create a significant intrusion by the Federal Government into the housing mortgage finance market. As if we haven't been a significant intrusion into the housing finance market for the last few years, i.e., the diagram that we just saw up on the screen. So, maybe we have gone too far even in this legislation and perhaps—and Mr. Wallison you sort of say that in your—at least at one point with regard to—we set out standards for the sponsors.

Can you comment as to why you think we are going essentially then an overreach when we try to do that? Is that a—

Mr. WALLISON. Mr. Chairman, I don't think you are going too far. I think it is a good idea.

Chairman GARRETT. Okay.

Mr. WALLISON. I think it is a responsibility of Congress after what we experienced in 2008, to do something about the problem of gradual mortgage quality deterioration as a housing bubble grows. The proposal that was made in the Dodd-Frank Act and adopted there, the 5 percent retention, will not work.

What will work is providing certain basic prime mortgage standards that would be available for securitizations. That will prevent the private market from going out of control, as it occasionally does, when bubbles begin to grow.

Chairman GARRETT. I appreciate that. You are going down a slightly different road—maybe I didn't ask my question clearly enough. We set also, besides the standards there for that, standards for the securitization; and then with the standards or certification, if you will, in the bill for the sponsors—for the issuers as well.

I thought I read in your testimony that you said if we do that, we create impediments to folks coming in and being that.

Mr. WALLISON. I am sorry. I didn't understand your question. I am concerned about setting standards for securitizers because I don't think they are necessary. I think especially if you are setting standards for the financial capabilities of securitizers, it adds cost for them, makes it less likely that more organizations will become securitizers, and thus reduces competition and the efficiency and innovation that will occur in that market.

The really good thing about securitization is that the purchasers of mortgage-backed securities in securitizations are protected by the subordinated pieces in those securitizations, not by the quality—the financial ability to respond—of the sponsor or the securitizer. Now, I understand that some people may be concerned about whether they are financially responsible, but we have to create a balance here.

What I am always afraid of is that government regulation, which always imposes costs, will keep many people out of the securitization business who could otherwise profitably engage in it.

Chairman GARRETT. Okay, I have to think all these through.

Mr. Hughes, you started to—and maybe I just didn't hear the next step with regard to the second lien provision? And you sort of said, "Okay, what we have in here is good," but then you said, "But, hey, there is a next step."

Mr. HUGHES. The second lien provision, I think there should be some limitation on a borrower's ability to take out the second mortgage, all the way up front so that there would be a test. And it would be a test that the combined loan to value of a first mortgage combined with a second mortgage couldn't be over 80 percent.

Chairman GARRETT. Okay.

Mr. HUGHES. There would be an approval by the first mortgage lender. So the first is not disadvantaged as a result of someone taking out a second mortgage.

Chairman GARRETT. But can you walk me through in a real-world experience how that actually works?

Mr. HUGHES. It requires an amendment to the Garn-St. Germain Act.

Chairman GARRETT. It is hard.

Mr. HUGHES. I know you mentioned—and everybody says it is impossible to amend it, but therein lies the problem. So I think there are ways to get there. But just being able to allow a borrower or another lender to hand out and give out another mortgage after the fact is very, very problematic for AAA investors.

Chairman GARRETT. Mr. Wallison, on that point?

Mr. WALLISON. In commercial lending, Mr. Chairman, the first lienor always has the right to approve whether there will be a second lien on the same property. In this case, if the first has the approval right and a second lien is proposed, the first always has the choice whether to decide to allow a second lien or not. If he decides not to, he runs the risk that the mortgage will be refinanced away from him. So there is a choice that is given to—

Chairman GARRETT. Right. And I know what we have here but one of the tricks is the notice requirement, I guess, on how you do all this. And I guess you have to work faster; we have language here. I am out of time, but Ms. Ratcliffe, did you want to chime in on that point? No? Well, then, I thank the panel for the answers.

Mr. Green is recognized.

Mr. GREEN. Mr. Chairman, I know you are a stickler for time, but given that we don't have a really long line today—

Chairman GARRETT. I will give you an extra 15 seconds.

Mr. GREEN. No, not for me.

Chairman GARRETT. Oh.

Mr. GREEN. My suggestion is that you be a little bit more liberal with yourself, and I am not going to object. So by unanimous consent, I would agree that you should finish your question.

Chairman GARRETT. I very much appreciate that. I will yield to the gentleman if he has questions. We can go around again for another round.

Mr. GREEN. All right.

Chairman GARRETT. But that was very nice of you to offer.

Mr. GREEN. Thank you, Mr. Chairman, and I thank the witnesses for appearing.

Let me start with Mr. Deutsch. It is good to see you; it has been a while.

Mr. DEUTSCH. Yes.

Mr. GREEN. And I would like to start because you mentioned that there would be an increase in the product, but that increase was not going to be exponential. Is this correct?

Mr. DEUTSCH. An increase in the product of private mortgage securities?

Mr. GREEN. Yes, sir.

Mr. DEUTSCH. Yes.

Mr. GREEN. And I am just curious as to how you arrived at, I think it was $40 for a loan at a value of, what was that value again, please?

Mr. DEUTSCH. $700,000. A $700,000 loan, so—

Mr. GREEN. A $40 increase.

Mr. DEUTSCH. I will run through the quick math of how the conforming jumbo market has changed. On September 30th, obviously the loan limits went down from $729,000 to $625,000, approximately. If you were to look at yesterday's mortgage rates, a jumbo conforming is about 4.5 percent; a loan that is a jumbo loan that is not conforming—that is the GSEs wouldn't be willing to buy it—was about 4.5 percent.

So it is about 25 basis points difference. Senator Mendez's amendment would say that the rate on the conform launch should go up 15 basis points, that there should be an extra fee on it.

So the difference you are looking at for conforming loans—conforming jumbo versus a nonconforming jumbo would be about 4.4 percent with a government guarantee and 4.5 percent for the non-government guarantee, which on a $700,000 loan, works out to be about $40 a month.

Mr. GREEN. Let me ask you this, we don't find a lot of these loans being accorded in the market currently, do we?

Mr. DEUTSCH. It is about 3 percent of all mortgages nationwide were in the $625 to $700—

Mr. GREEN. My point is if there is some concern about the loan itself in terms of—cost doesn't appear to be a factor. What would be the factor that causes these loans not to be a product that consumers are eager to purchase?

Mr. DEUTSCH. I think consumers are eager to get loans in that band, if that is the price of the house that you are looking for. Obviously, there are not that many million-dollar homes out there that people are looking to purchase, but there are a substantial amount.

Mr. GREEN. All right, let me move on and ask—let us see.

I believe Mr. Wallison—is that correct, sir?

Mr. WALLISON. Yes, sir.

Mr. GREEN. Thank you. You have indicated that this would repeal the risk retention provision in Dodd-Frank and you indicate that would be a standard set for securities and, of course, there will be no Federal backstop any place in this process. Is that correct?

Mr. WALLISON. Yes, that is correct.

Mr. GREEN. Okay, let us start with the notion that there won't be a Federal backstop. Is it your opinion that there will be a great demand for the products absent a Federal backstop?

Mr. WALLISON. Absolutely. My discussion with people in the private sector, and also just simply thinking about it, would indicate that once the Federal Government is out and there is no risk-taking by the Federal Government and no subsidy of government risk-taking by the taxpayers, the private sector would be very happy to take mortgages and mortgage-backed securities that produce market-based yields.

As I mentioned in my testimony, the fixed-income buyers of securities like insurance companies and pension funds really need market rate securities like mortgage-backed securities. They don't have them to invest in now because of the domination of the market by the GSEs.

When these mortgages become available through a private market, these buyers will step in and be major supporters of the mortgage market, which will help housing buyers, the housing market, and of course, give the buyers the diversification that they need.

Mr. GREEN. I don't know that I am going to adamantly differ with you, but I talked to a lot of people and—but most of the people that I talked to have a different opinion, so perhaps you and I should talk more and perhaps you can enlighten me to a greater extent—

Mr. WALLISON. I would be happy to do that.

Mr. GREEN. —but I just don't find that is the case.

One more thing, you do agree that part of the reason we are in the trouble that we are in now is because the originators were not concerned about whether persons were able to pay; they were just originating loans that they could pass on.

Well, if we eliminate the risk retention, how will the standards prevent this from occurring again—just standards alone—because we had standards before? And this will be my last question, but I would like to hear your answer, given that we had standards before, and we had the risk passed on to others, even with standards.

Mr. WALLISON. This is a much more complicated question than simply those transactions.

What happened was that the government was interested in buying mortgages or having Fannie and Freddie buy mortgages irrespective of the quality of those mortgages, because Fannie and Freddie were required to reach certain quotas in the purchase of mortgages for people who were at or below the median income in the areas where they live. That created what would always happen when the government says, "We will buy whatever you can produce; we are not worried about the quality." Those things are produced and that is how we got to the situation we are in. That is one of the reasons why I am very much afraid of returning to a market in which people are no longer interested in the quality of the mortgages that are being produced.

That can also happen when a bubble develops in the housing market, because the tendency of a bubble is to suppress delinquencies and defaults, so mortgages and mortgage-backed securities look safer than they actually are. That also produces excessive demand for low-quality mortgages, which have high yields.

What this bill would do, as I understand it, is set minimum standards for mortgages that can be securitized. They would be called prime mortgages. And if it is possible that can be done—and I gather that Mr. Demarco believes it is—we could avoid many of these problems of deterioration in mortgage—

Mr. GREEN. Would it surprise you to know that Dodd-Frank sets some minimal standards?

Mr. WALLISON. I don't know that I have seen in Dodd-Frank anything that requires a certain minimum standard. What Dodd-Frank is trying to do is to penalize people who do not securitize a Qualified Residential Mortgage (QRM). But a QRM, as now defined, at least by the regulators, is a mortgage that is far more of a prime mortgage than it needs to be. It is a much more difficult mortgage to obtain.

There would be many, many mortgages that are not as high quality as the QRM has proposed, which could be securitized by the private sector or the—

Mr. GREEN. So this bill lowers the standard?

Mr. WALLISON. I don't know that it would lower the standard, we haven't seen what those standards would be, but it would probably involve less than a 20 percent downpayment.

Mr. GREEN. Thank you, Mr. Chairman. You have been generous. I will wait for the second round.

Thank you.

Chairman GARRETT. Sure. Thanks.

The gentleman from Arizona?

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

Mr. Hughes, you are literally one of the only folks, I think in the market over the last couple of years, who has actually done an MBS securitization.

What do you think the appetite is out there right now for mortgage-backed debt?

Mr. HUGHES. I think the appetite out there is very high; having said that, it is going to require that you meet their standards.

A lot of those standards are what are built into this bill and what we have put into the existing bills that are out there. We are not going back to the days where they are going to buy subprime securities. Where I really think there is the biggest securitization market is for prime—so to the extent that loans that look a lot like the Fannie and Freddie loans, I believe investors would buy on the private side, to the extent that you meet the criteria for transparency disclosures, fairness of collateral protection.

Mr. SCHWEIKERT. Of properly packaged.

Mr. HUGHES. Properly packaged.

Mr. SCHWEIKERT. Okay.

On the previous panel, Mr. Demarco talked about holding, what, almost a trillion dollars in mortgage debt. I am assuming that was both performing and nonperforming.

If he were to come to you and say, "Here is $100 billion of performing GSE debt, but we would like to strip the Federal guarantee," is there a hunger for that? Is that something someone like yourself would package in one securitization and sell?

Mr. HUGHES. That is something that we would be interested in to the extent it is from current production. I don't know that we would want to jump into the older loans.

Mr. SCHWEIKERT. Okay, so 2009 and later?

Mr. HUGHES. To the extent that there was a billion dollar pool, and the credit enhance point was five points on that pool, Redwood would absolutely consider—to the extent that it met the criteria and if you look at the average criteria for the Fannie/Freddie pool, they look a lot like the Redwood-type pools except the loan size is more.

Yes, we would buy them, and I think there is a pretty deep market to do that.

Mr. SCHWEIKERT. And that is sort of an open question for anyone on the panel because I have been trying to get my head around the appetite for fixed-income mortgage-backed loans that would be lineage from really the last 3 years. So we know it is written at a readjusted real estate value, probably with a much tighter underwriting standard, and how much of that debt would be consumed even without a Federal guarantee. But at the same time, if it was consumed in different types of securitization, would that also help us build exactly what Chairman Garret is doing here is the flow in the system and the pipeline?

Am I making a mistake somewhere?

Mr. HUGHES. No.

Mr. DEUTSCH. To jump in, I think there is a degree with Mr. Hughes, there is a significant appetite from investors for mortgage-backed securities. Ultimately, the question every investor will ask is, what is the price? And many if not any investor will buy the appropriate price or the price that they would be willing to purchase at.

One of the key challenges of the last few years is sort of the price and sort of the supply/demand equilibrium has been off and that investors are demanding higher prices and want to see higher prices where they and where as issuers want to issue them at lower prices or lower yields and those are just starting to come into the equilibrium and you are seeing some transactions like Redwood come out into the marketplace.

Mr. SCHWEIKERT. In my last minute-and-a-half, Mr. Demarco calls one of your members and says, “Hey, I have $100 billion of performing mortgage debt, I want to strip the Federal Government guarantee off of this,” what would be the barriers that you would see within the securitization world right now? Is there a reps and warrants issue? Where do I have an Achilles heel?

Mr. DEUTSCH. The first question, as I indicated, would be the price. What is the price you are trying to sell me those at, and what do I value that as?

In terms of the other barriers, reps and warrants, assuming that Fannie and Freddie have bought these, they have pretty stringent reps and warranty requirements in place so most investors would take those as appropriate reps and warranties there in place. Some may want some more repurchase requirements similar to what has been promulgated out into the market, but I think those loans would be able to be sold out into the secondary market again, just depending on what the price was.

Mr. SCHWEIKERT. Ms. Ratcliffe, would you have any objection to seeing the GSEs right now at least offer some of their debt and see if they could literally go out in private places?

Ms. RATCLIFFE. I think there would be a lot of benefits in at least getting price discovery. I think the questions you have to find out are—I don’t think there is an $11 trillion appetite. I think the questions that will come up are, “What price?” and “Using what products?" and "For whom?" And so, I think that price discovery would help show what the real gap is.

A lot of people refer to this 40 to 60 basis points difference facing jumbo borrowers in the fixed-rate market versus GSE execution. I think that is a little misleading because it is exactly the jumbo borrowers who can access that kind of product efficiently without any government support. So it is not surprising—

Mr. SCHWEIKERT. Mr. Chairman, with respect to—actually, the price discovery is one of the things I have great interest in, because, in a weird way, this is also debt that has some performance history. So actually, it may carry somewhat of a premium on my credit risk side. But I have also been trying to do some quick calculations, saying, "Okay, if this debt from the last couple of years," and with the Federal Reserve trying to move us out from the WAM, my 30-year interest rate is here today—there may be a premium to the GSEs right now on that debt from just a yield standpoint.

All right.

And thank you, Mr. Chairman. I am sorry I went over my time.

Chairman GARRETT. It will be remembered.

The gentleman from California?

Mr. CAMPBELL. Thank you, Mr. Chairman, and thank you, panel.

Mr. Hughes, your re-securitizations were often held up by a lot of people as an example of what could occur if there were no government guarantee in any segment of the market. I have a report from Business Wire here dated September 27, 2011. It talks about your last securitization.

And it says, "The weighted average original combined loan-to-value ratio is 64.2," meaning an average 36 percent downpayment, "and a weighted-average original FICO credit score of 773," which, last I checked, I don't have. So that is a very high down, very high-credit type of issuance you are making, correct?

Mr. HUGHES. Correct. A couple of observations: If you were to go look at where Fannie's and Freddie's executions are, you would see 750 FICO scores, and you would see a probably a 70 percent loan-to-value.

So they are not that dissimilar. And then probably the bigger comment is, with everything getting sold to the government or on a bank's balance sheet, they are the only loans available for us to buy and securitize.

If we had access to more loans, but there are no loans to buy. With 95 percent of them going to the government, we are constrained in what we can buy.

Mr. CAMPBELL. Mr. Hughes, I find that also another from this is that the average balance is $793,000; so these are, as we say, not conforming loans. These are in the jumbo market.

I come from the Newport Beach/Irvine area of Orange County, where my average house price is higher than this. So I can tell you there are plenty of people who are trying to buy houses and trying in the jumbo market without any government support, trying to buy houses with 20 percent down, trying to buy them sometimes with 40 percent and 50 percent down, and with FICO scores of 740 and 715, and they can't get a loan.

So I would suggest that—to say that you can't find those loans—there have to be plenty of loans out there with lower FICO scores and lower downpayments than this.

Mr. HUGHES. Redwood Trust is not an originator or a servicer. So what we do is align ourselves with banks, large mortgage companies, and then draw from their distribution network. So we can only draw in—

Mr. CAMPBELL. Okay, but doesn't that mean that somebody along the line, maybe because of the risk retention requirements, maybe because of your ability to sell into the secondary market, once these kinds of downs and these kinds of credit scores without a government guarantee, they are not—I have a Dow Jones report on the same thing from September 20, 2011, which says, "Redwood and lead manager Credit Suisse raised the coupon to 3.9 from the expected 3.6 set for investors. One of the speculators said investors are concerned about low yields they are being asked to accept to take the credit risk," which, obviously, when there is a government guarantee, that credit risk is out of the equation.

So that means that somewhere along the line—

Mr. HUGHES. I would disagree with the conclusion for the reason that we went from 360 to 390, and I would point to the disruption in the financial markets and widening of credit spreads across the board.

Mr. CAMPBELL. Okay, but back to my original point, there are plenty of people who would love to buy a house in the nonconforming market with 10 percent down or 20 percent down who don't have this kind of credit score. Somebody along the line won't make them loans.

Somebody along, in the—or else you could package them and send them out, because there is no government competition there, or somebody else would do it. It just seems unreasonable for me when, in this area of the market, where there is no government competition, to say that the loan demand out—if you are the only one doing it, why isn't somebody else doing 10 percent loans or 20 percent loans down?

Mr. HUGHES. I don't know.

Mr. CAMPBELL. Okay. Mr. Deutsch, I spoke to the American Securitization Forum, to your group, back in June. And I asked the group—there were 200 or so people there—whether they would transact in the TBA market without a government guarantee on the securitization. And I asked people to raise their hands. Not a single hand in the room went up. I then said, "Let me repeat it. Make sure you all understand: Will anybody in this room do it?" Not a single hand in the room went up, and I then said, "Let the record show that no hands went up."

Was that a totally nonrepresentative part of the American Securitization Forum, or how can we—if that is correct, how can we have a robust securitization market without a government guarantee if nobody is going to go into the TBA market with it?

Mr. DEUTSCH. We certainly appreciate your participation at our annual meeting, Congressman Campbell.

I would say the one key factor that was omitted from asking that question is what the price would be. As I indicated before, I don't think you will get any investor to say they would be willing to transact without knowing what the price is, what the yields would be, and I think that is where, if I was sitting in that audience, I wouldn't raise my hand, because I would want to know and negotiate that price.

Mr. CAMPBELL. Okay, then the question is: What is that premium? And I realize my time has expired. So I have lots more questions, but I think we are doing a second round.

Chairman GARRETT. Sure.

The gentleman from New York is recognized for 5 minutes.

Mr. GRIMM. Thank you, Mr. Chairman, and thank you to our panelists.

I appreciate you coming in and giving us your testimony today.

Mr. Deutsch, can you just go into a little bit about how the GSEs underprice credit risk?

Mr. DEUTSCH. I think what you see in the current market right now is the GSEs have what they have a guarantee fee that they charge to people selling into their securitizations effectively. You can look at various ways.

I think FHFA has a good report out on how that guarantee fee is effectively underpriced so that if you sell a loan to Fannie and Freddie, and they will sell it out to mortgage-backed investors, when there are a higher delinquencies or defaults, particularly over the last few years.

Over time, those aggregate to be more in terms of losses than their guarantee fees that they are charging, which is one explanation of why you had $169 billion flow to Fannie and Freddie from the U.S. taxpayer.

Mr. GRIMM. Thank you. And one other question to you as well, I think it was you who mentioned, "Death by 1,000 regulatory cuts," and, as you know, a lack of private securitizations. Can you just describe that a little bit, please?

Mr. DEUTSCH. Sure. I think what we have seen over the course of the past couple of years, there is no question in our minds, in our membership's minds, that additional reforms to securitization have been necessary, and we have been very supportive of things, even such as a basic risk retention requirement, as well as it doesn't have bells and whistles like a premium capture cash reserve account and other items that aren't called for in the Dodd-Frank Act.

But those 1,000 cuts, when you add up so many different regulatory initiatives, it makes it very hard for private sector capital to flow back into this market, because if you are—think about if you are running your own business, you have 10, 20, 30 regulatory initiatives coming at you, you don't know how they are going to come out—it is very hard to go to your boss and say, "Hey, we need to build up some infrastructure here. We need to build up and hire more staff, but we don't know what is going to happen with Fannie and Freddie. We don't know what is going to happen with these QRM rules. We don't know what is going to happen exactly with Basel III."

It makes it very challenging to be able to build and run a business, and proud folks like Mr. Hughes, who have been able to come out in the market, get some transactions going, and be prepared for when the market does turn.

But I think most of our market participants would say that may be years down the road, particularly given the uncertainty around what will happen to Fannie and Freddie.

Mr. GRIMM. Thank you.

Mr. Hughes, I think you have been critical of QRM, and if you could, just very briefly describe to me what is wrong with the proposed QRM.

Mr. HUGHES. We haven't been that critical of QRM. Actually, for the whole risk retention, we are probably one of the few people who were in favor of the risk retention rules.

But I would say, generally, where risk retention has come out in the proposals, and with premium capture and where it is going, it is just too cumbersome to actually make work. So I would say, from a Redwood standpoint, we would agree with the proposal, rely on representation to warranties rather than a narrow definition of QRMs.

Mr. GRIMM. Okay. Thank you.

I am going to throw this out to the panel. I have often said that the economy won't fully recover and turn around and grow until we get the housing market turned around. I just think it is too big a sector. And if you could pick two things that you think that Congress should make paramount, maybe we will get those who haven't spoken yet, what would they be?

Ms. RATCLIFFE. I have one.

Mr. GRIMM. Okay.

Ms. RATCLIFFE. And it is a little theoretical here, but actually, a colleague, Phillip Swagel at AEI, I would sort of paraphrase what he has said, that we should recognize that whether there is an explicit or an implicit or an unstated government guarantee, the government is always going to step in to preserve markets.

And so if you all could come around to making a confirmatory statement that you do see a role for some kind of limited government guarantee, at least in the foreseeable future, for supporting the middle of the market, or the sort of the conforming space that it is today, I think that would send a tremendous signal to the marketplace to begin planning ahead and moving forward with a comprehensive understanding of what the market is going to be like. Just sending that signal along and moving forward with figuring out how to structure that guarantee.

Mr. GRIMM. Thank you.

Go ahead, sir.

Mr. WALLISON. I am glad to be able to point out that everyone at AEI does not agree. My view is the opposite, and that is, to the extent that we have any government involvement in the market, we will rekindle the kinds of problems that caused the financial crisis in 2008.

What we ought to be sure that we do have is market discipline, with firms being able to fail, and firms that market poor quality mortgages bearing the costs of that, and/or the investors bear the costs of that. So I would strongly oppose any system where we introduce the government to support the housing market in any way. I think it can be done perfectly well by the private sector.

Mr. GRIMM. My time has expired.

Thank you.

Chairman GARRETT. The gentleman yields back.

And without objection, we will do a second round. I would like to do it just for the dedicated people who are remaining here, but I am told I am not allowed to exclude other Members from coming in by sealing the doors, or what-have-you. But be that as it may, I will start the second round and then go through it.

So from the testimony, what we hear is in one respect, and we have heard this before, that part of the issue is that it is a supply problem, and not a demand problem; that there is a demand out there. And there is a supply problem as far as the security from the underlying—from the lack of mortgages underneath them.

But to the gentleman from California's question, I think it was a good question. I think, "Why isn't this happening above the conforming loan limits right now?"

And Mr. Hughes, could it partly be in fact that with the bank balance sheets as they are, that the banks—and I see Ms. Ratcliffe is nodding her head—that the banks are just picking these things up, since these are the million dollar homes. And these are the ones—I will let either one of them—Ms. Ratcliffe, is that what is happening, do you think?

Mr. HUGHES. That is, in fact, what is happening.

Chairman GARRETT. And Ms. Ratcliffe agrees? Yes?

So I guess that answers that piece of it. I can't, obviously, explain what the particulars are in any anecdotal story as to why in certain cases, people aren't getting the loans that they are looking for. I know I personally have a good credit rating score and I have a job, but I would not be able to, right now, much as I would like to, go and get a loan for $700,000, because I am on a fixed income.

But to Ms. Ratcliffe, and anybody else on the panel as well, the issue here is—and I think what we are trying to do here is to change the focus from the focus by investors to being on from the credit rating of the United States, which is having problems by itself, to the credit ability of the borrower. Isn't that really what we should be trying to do?

Ms. RATCLIFFE. Peter and I can continue to have our debate forever, but it is not going to advance the market. And I think if we can say we are going to find a minimum appropriate role for government—

Chairman GARRETT. Okay.

Ms. RATCLIFFE. —as well as the responsibility for borrowers, and start moving towards structuring that—

Chairman GARRETT. Right.

Ms. RATCLIFFE. —that is what I am calling for here. Our plan at the Mortgage Finance Working Group foresees using mostly private capital in this sector with an FDIC-like model, where exhausting the balance sheets of the securitizers, the issuers, you would then have a pooled fund that you could go to and only super-catastrophic government guarantee.

Chairman GARRETT. Yes.

No one is suggesting that we would not—I think someone else testified to this—no one is suggesting that we are not having a government involvement in the housing sector, because even with this, if this was to happen tomorrow—and no one is suggesting that this is happening tomorrow—is that you would still have—who said it?

You would still have the FHA; you would still have the EVA; you would have Ginnie Mae; you would have the Federal Home Loan Banks; you would have the mortgage-interest-deduction aspect. I know that plays into how things finance in the sense that we support borrowing that way; right?

And of course, there are probably a myriad of other Federal programs, I think some of which I guess Ms. Ratcliffe is referring to as far as supporting—supporting people as far as community programs and the like; so all of those would remain out there.

So I guess that—and maybe to the point that Ms. Ratcliffe raised—to the extent that what would happen if you did something to send a signal to the marketplace, if you did something on top of that—and I guess, Mr. Wallison and I will open it to anybody else—what signal would it be if you say, well, we are going to continue to have a backstop to the marketplace?

Would you get the same response then from your investors, Mr. Deutsch, as far as they are saying, well, we are going to wait and see then, until—

Mr. DEUTSCH. I think if you are selling out securities to investors—

Chairman GARRETT. Yes?

Mr. DEUTSCH. —and you tell them that there is an implicit backstop, or they get the sense that there is an implicit backstop to those securitizations, that will make it more desirable to them. And the fact that they will be able to go back to the government if the government—

Chairman GARRETT. So they will go there, as opposed to go over here? That they will go over to the government—

Mr. DEUTSCH. Right. If you have a choice, if you are sold a private security and you are sold a public security, and they are at the same yield, you will choose the public security every day, because you have the U.S. Government as a backstop. Then, it becomes a quality covered bond by the U.S. Government.

Chairman GARRETT. Right.

Mr. DEUTSCH. But if you have just a private securitization out there, they will demand a little bit more yield, because they don't have that backstop behind it.

Chairman GARRETT. And Mr. Wallison?

Mr. HUGHES. And to the credit backstop, there is a difference in liquidity as well.

Chairman GARRETT. Right.

Mr. HUGHES. So it is something they could readily borrow against to the extent that it is an agency security.

Chairman GARRETT. Right, and that is what we are trying to do here is trying to get the liquidity up so that you can get all of the markets to give it to the market.

Mr. Wallison, do you have a comment?

Mr. WALLISON. I think that as soon as people believe that the government is going to remain in the market in some way through a guarantee, they are not going to put any investments—or put in the activity—to become securitizers, or work themselves into that field. It just doesn't make sense if you think you are going to be competing against the government.

A government backstop will have exactly the same effect as the government actually guaranteeing, because it will just mean that the value of the government backstop is included in the risk profile and reduce the return.

And because it reduces the return, private investors will not be particularly interested in it. So you have to really give the investors a signal, not only the securitizers, but also the investor market, that the government is getting out. And one way to do that, of course, is first to provide for the gradual winding down of Fannie Mae and Freddie Mac—

Chairman GARRETT. Yes.

Mr. WALLISON. —and then, give them assurance that no other government activities similar to Fannie and Freddie, whether implicit or explicit, is going to be put into place to replace them.

Ms. RATCLIFFE. And with all due respect, if I could disagree with Mr. Wallison, I think staying stuck on this point is supporting the status quo with 90 percent of the market being supported by 100 government guarantee. And the challenge is to figure how to limit the government guarantee so that there is a viable private sector, and so that the taxpayers are protected. And I think we can do that.

Chairman GARRETT. All right. So just since you gave me the—so what is happening right now, there is an issue as far as that guarantee with regard to the conforming loan limit. You saw what happened in the Senate.

The last question is for Ms. Ratcliffe: Should we be propping up the conforming loan limit, or should that be coming down?

Ms. RATCLIFFE. If you read our plan, which you know, in the long run, we certainly see that the—

Chairman GARRETT. But what about right now, because we have—as you said before—to get going.

Ms. RATCLIFFE. No, I agree. And I think the difficulty here is exactly what I am talking about. Some of these incremental steps are very hard to execute without a clear idea of where we are headed.

Chairman GARRETT. Right.

Ms. RATCLIFFE. And where we are headed, the government should not be guaranteeing those high-end jumbo lines.

Chairman GARRETT. So I will introduce for the record without objection the statement from the National Community Reinvestment Coalition, who on that point take the view that we need that direction to the marketplace, and we need for the conforming loans to start the trajectory down, as was put into law.

Without objection, it is so ordered.

Mr. Green is recognized.

Mr. GREEN. Thank you.

To make sure I understand where each witness is on this question—if you are of the opinion that there is no role for the Federal Government in this market, would you kindly extend a hand into the air? I think it will help me to see.

No role at all for the Federal Government? All right.

Let the record—

Chairman GARRETT. Clarify in what market, when you are asking this? The Federal home loan housing market?

Mr. GREEN. No, not the Federal home loan housing market.

Chairman GARRETT. I meant the Federal housing market, or just in guarantees?

Mr. GREEN. In the market that currently allows for the government to have it—it was implicit, but we have made it explicit now with the GSEs.

Chairman GARRETT. Okay.

Mr. GREEN. Because FHFA owns the GSEs, so that is we are talking about. So, is it fair to say that the record will reflect that one person, and that would be Mr. Wallison, you—

Mr. WALLISON. I am talking only about no government guarantees for middle-class prime borrowers.

Mr. GREEN. Yes.

Mr. WALLISON. There has to be a government program for low-income borrowers.

Mr. GREEN. Exactly.

Mr. WALLISON. —and so, we don't need the government in that.

Mr. GREEN. And in your opinion, but you are the only one? I just want the record to reflect this is the case.

Now, having that in the record, let me just say this. And I will get to you, Mr. Hughes, in just a second if I may, because my time is limited.

I want to go to you, Ms. Ratcliffe. Let us talk about this. And I hate to use this term, "apples and oranges," because it has become sort of a term that is not in good standing right now after some recent events and debates. But is it fair to compare the nonconforming with the conforming if we come to some conclusion about jumbos? Is it fair to use that for the entire market?

Ms. RATCLIFFE. I think your point is perhaps the same, that the benefits of having a government guarantee are able to be quantified or modified by looking at the spread between what does the jumbo pay for a 30-year fixed-rate mortgage, and what does somebody getting a government-backed or government-supported GSE loan pay for a similar mortgage product. And that spread doesn't look very big, and so people say there is really not that much value there.

And my point would be that, again, it is true that borrowers with big downpayments and good incomes should be able to tap into that kind of credit at very efficient rates without a government backing. We need to find out where that line is, and not have the government supporting that part of the market.

However, if you went deeper into the market, you would see, I think that these spreads seem much wider. And it is hard to know what that would be, because there is no real place to determine that. I also think that it is very unlikely that such a private market would provide the volume of 30-year fixed-rate mortgage finance that we are used to in this country.

And so, that is a factor that is not necessarily covered in price, but certainly in the risk that the borrower is taking on. That is a higher cost to them, because they are talking on great risk. And we have seen the consequences of that.

Mr. GREEN. Now, we haven't always had the government involved in the market. At one time, in the absence of the government, we had these loans that would have big balloons—short payment periods. People were not exactly eager to have their money on the line for 30 years.

It was after Fannie and Freddie got into this market that we found that product, especially for middle-class people and working people. They were able to afford homes.

Would you comment on this, Ms. Ratcliffe?

Ms. RATCLIFFE. Yes, it is true that before FHA was introduced, there was a basically non-existent market for fixed-rate mortgages and there was more volatility. And some of the things we saw sort of repeated in the private market in the 2000s.

But the nice thing about the 30-year fixed-rate mortgage is that the borrower knows what their payment is going to be over time, effectively, and what happens is, with even modest increases in their income, their debt-to-income improved and with even modest appreciation, their LTV automatically improves. And it creates an excellent source saving vehicle, right? Home equity is still a big portion of the retirement wealth in households retiring today, and that is largely thanks to the 30-year fixed-rate mortgage.

So that product in and of itself makes it possible for more households to be able to get into homeownership and do so sustainably. We studied a portfolio of 50,000 mortgages made in the decade prior to the crisis. These mortgages were made by 30-some banks around the country. And generally, the median income of these borrowers was $30,000, and most of them put down less than 5 percent.

About half of the credit scores at origination were below 680, and yet we have seen the default foreclosure rate on this program staying below 6 percent, even through this terrible crisis, which is much lower than you would see, for example, in the subprime market. And this is just one example that I have put forward where these borrowers all had 30-year fixed-rate mortgages that were prime priced and underwritten for ability to repay.

When we looked at those sort of identical borrowers who were given different kinds of loan products, we see that those identical borrowers with different products had default rates that were 3 to 5 times higher than those having the 30-year fixed-rate mortgages. So, that is the evidence about the additional stability of that product for—

Mr. GREEN. And Mr. Hughes, onto you now. Thank you for being patient, but I do have a question, and of course, you may have an additional answer. But my question to you is, with reference to the QRM, are you of the opinion that it cannot be adjusted such that it would be suitable?

Mr. HUGHES. I think with the QRM tied in with risk retention, tied in with premium capture, it would be very difficult to try and unbundle it in a way where you could really get something that is actionable for people who would be originating loans and then securitizing them.

Mr. GREEN. My time has expired. Thank you.

And thank you, Mr. Chairman.

Chairman GARRETT. The gentleman from Arizona for 5 minutes.

Mr. SCHWEIKERT. Mr. Chairman, with your permission, can we do a lightning round? Actually, you are the victims of the lightning round.

I would love to actually just throw out a couple of the mechanics within my understanding of trying to get to a securitization of MDS and all the things I hear about and just your quick comment. How much more definition has to be in regards to servicing standards, particularly on the impairment side?

Mr. DEUTSCH. I think that there will be within private-label securities a lot more additional work that has to be done to pull in the servicing agreement to clarify the servicing standards. But a lot of that is going to be done through private market mechanisms for investors to get comfortable with how servicing will work on a go-forward basis.

Mr. SCHWEIKERT. Okay, on impairment?

Mr. DEUTSCH. On impaired loans.

Mr. HUGHES. Same question?

I would agree with Mr. Deutsch.

Ms. RATCLIFFE. Nothing to add.

Mr. WALLISON. Nothing to add.

Mr. SCHWEIKERT. Okay. How about on the TBA market?

From a quick standpoint, how do you see it working under Chairman Garrett's bill?

Mr. DEUTSCH. For servicing standards?

Mr. SCHWEIKERT. No, TBA, to be announced.

Mr. DEUTSCH. I think for any private label security and private originations can replicate being able to rate lock borrowers. The price of replication will be a bit higher and doing it through the private markets. But it can replicate being able to lock borrowers in.

The price of replication will be a bit higher doing it through the private markets. But it can replicate being able to lock borrowers in. But I think the real question for secondary market buyers is the liquidity of the securities without a government guarantee, is being able to move—you can call things homogeneous. Then they could be relatively homogenous mortgage loans.

But once you start creating loan-level data in a secondary market for what would be TBA-type loans, without that government guarantee, then they start making differentiation between those loans, and that does impair liquidity, to an extent.

Mr. HUGHES. I would say one of the things that we need to think through is: What is the proper subordination level? In addition, do you need these securities to be rated? I know we have tried to accomplish securitizations without ratings to just see if we can get investors together. It is very, very difficult.

So I would say, in getting a liquid TBA market, we need to think subordination levels, and we need to figure out whether or not a rating will ultimately be attached to the security.

Mr. SCHWEIKERT. Yes.

Mr. Chairman, would you need that to be able to produce a 30-day forward or what would create that distribution—

Mr. HUGHES. One of the things, as I tried to start out in my testimony that we are a little fuzzy on, is some of the ideas and thinking it through, and I think probably what we need to do is, from our side, is vet it more with investors, to just begin to socialize it and take it—

Mr. SCHWEIKERT. Yes, we would love that input, because I know that is something we are all talking about, asking, are we giving enough guidance to make sure that the private market is able to cover that need?

Ms. RATCLIFFE. I totally appreciate the emphasis on the TBA market in this bill, and the emphasis on standards and granularity and categories and loan level data. The problem is there is a tension between these two things.

If we do get to category ST, XYZ of loans, and you spread that across multiple issuers and with different subordination levels, and also the different—the nice thing about the Fannie/Freddie product is also 30-year fixed-rate mortgages, whereas, in the private-labeled sector, you see a little more complexity of instrument and cash flow. So I think it has sort of met its challenge.

All of that said, I agree with Mr. Hughes that it is time to start exploring these things and trying some things out and see how they could be made to work.

Mr. WALLISON. My understanding is there was a TBA market before there were Fannie and Freddie securities, and one will be created again by the private sector. The real issue in TBA market is simply liquidity. And that is why, to the extent that there are different classifications produced by FHFA here, that there not be too many. We would have relatively few classifications of prime mortgages that are securitized, which would allow some depth in that market. All you need is liquidity, and then it works. It has nothing to do, really, in my view, with a government credit.

Mr. SCHWEIKERT. In our last 30 seconds, give me one or two changes you think need to be out there for the M.I. markets.

Mr. DEUTSCH. For the which?

Mr. SCHWEIKERT. Mortgage insurance.

Mr. DEUTSCH. We don't have any strong views on the changes in the M.I. market.

Mr. SCHWEIKERT. Mr. Hughes?

Mr. HUGHES. For the market that we are working with, private investors really the—there is very little M.I. that is applied to jumbo loans. So we don't really have opinions on that.

Mr. SCHWEIKERT. Ms. Ratcliffe?

Ms. RATCLIFFE. I am not sure what I would do to change the M.I. market. I guess it is worth recognizing that—and we haven't touched on this in the discussions of the bill, because it is really not in there.

But another approach to improving the functioning of the market is not only to improve the pricing of risk, but to improve the levels of capital across the industry sectors that are decked against the kinds of risks people are taking and rationalize that to avoid adverse selection.

And the mortgage insurance companies actually have a very interesting model for capitalization that requires them, if their stockpilers are—during good times and sort of countercyclical, and then they draw down those reserves during like this as we are seeing they are.

They have paid some $27 billion or so in claims to Fannie and Freddie, saving their taxpayers that money. And actually, they are allowed to fail. They are not too-big-to-fail. But that capital is being drawn down on. I think it is a model worth considering if they—

Mr. WALLISON. Okay. I think mortgage insurance is extremely important if we want to bring in institutional investors, for example, because mortgage insurers will do their own underwriting.

Mr. SCHWEIKERT. Are there a couple of changes you would make in today's M.I. world?

Mr. WALLISON. That I would make? No. M.I., of course, is regulated at the State level, and in most cases, it has worked pretty well. They have survived, with few exceptions, during this terrible financial crisis.

So it is a regulatory system that has worked well so far, and we ought to make more use of it—especially when we have a situation where the rating agencies no longer have public confidence. Mortgage insurers can provide that confidence.

Mr. SCHWEIKERT. Forgive me. I am way over my time. Mr. Chairman, thank you for your tolerance.

Chairman GARRETT. Not at all.

The gentleman from California?

Mr. CAMPBELL. Thank you, Mr. Chairman. I guess I am the cleanup hitter here. And I am first going to make a couple of comments myself and then get to a few more questions.

The chairman asked a question relative to a question I had posed before about, perhaps why in this jumbo market there weren't a lot of lower down or lower credit loans. And by the way, I bring that up not because $800,000 loans are a norm by any means, but just that is completely unaffected by Fannie and Freddie and by a government market.

But the answer that everybody gave was that the reason for this was bank balance sheets and so forth and so on, which, for those of us like myself and Ms. Ratcliffe, who believe there ought to be a limited government guarantee, explicit but limited, with lots of private capital up front, in order to provide the fungibility that you are looking for, Mr. Deutsch, and the liquidity that you are looking for, Mr. Hughes, those of us who believe that.

The bank balance—that is exactly the point. That is exactly the point. The housing market is such a huge part of the economy. It is such a gigantic part of each individual's, as was all discussed here, personal net worth, and in fact, their retirement savings. Banks are cyclical. Everything is cyclical. And when they want to loan to everybody, as we have seen, they will loan to anybody. And then, you probably don't need government guarantee.

But when they go off like they are, then what? Then, nobody can get a loan. Then, nobody can sell a house. And then, all kinds of problems happen. And it will be procyclical. It will make recessions into depressions and it will make booms into bigger booms.

And that is why this kind of stability that I think Ms. Ratcliffe and I are seeking, which also provides that fungibility and that liquidity that Mr. Hughes and Mr. Deutsch are looking for, is the sort of thing that we ought to be adding here.

But Mr. Wallison, let me just—because I had to bring up—you mentioned private mortgage insurance, and we haven't mentioned at all the failure of PMI organization based in Mr. Schweikert's State, and I know you believe governments can't properly price insurance. Isn't there an argument to say that PMI didn't properly price private insurance either?

Mr. WALLISON. One of the reasons government doesn't properly price is that it doesn't have the incentive to price properly. It has an incentive not to price risk, because that works better politically. But the—

Mr. CAMPBELL. Whoa, whoa, whoa. Okay, well, there are a lot of things that government does that can work different politically than—

Mr. WALLISON. Yes.

Mr. CAMPBELL. —that is why you have to try and take that pricing out of our hands, because you are right; we will price it politically. That is not the right thing to do. But go on.

Mr. WALLISON. I am just suggesting why it is that the FDIC and many other agencies that are supposed to be risk pricing their insurance don't do it properly. But in the case of insurance companies, they have the incentive to do it. They do it by creating a reserve fund. The fund gets larger and larger over time, and that is what—

Mr. CAMPBELL. But private mortgage insurance right now is under huge stress, right?

Mr. WALLISON. Yes, but—

Mr. CAMPBELL. —for the failure of PMI in the swaps market, it is under huge stress. And understand; I believe there ought to be private insurance. I am not saying there shouldn't be. In fact, I think it is an important part of the market. But they have mispriced it.

Mr. WALLISON. Well, yes. They mispriced it, but they are—

Mr. CAMPBELL. Okay. Thank you.

Mr. WALLISON. No, let me finish because I think it is important—

Mr. CAMPBELL. I will get cut off, so let me.

Ms. Ratcliffe, did you have a—

What is that? All right.

Chairman GARRETT. It is your time. We will allow it.

Mr. CAMPBELL. If you want to give me more time, I will let him finish.

Chairman GARRETT. Yes, I will give you—we are over time anyway, but I will give you the additional time so Mr. Wallison—

Mr. CAMPBELL. Okay. Go ahead, then.

Chairman GARRETT. Yes.

Mr. WALLISON. The way that the insurance companies work is they create reserve funds, which they allow to grow over time. They are pricing for catastrophic circumstances by creating these funds. And by and large, that is how the mortgage insurance industry has worked.

There are two or three which have been in trouble. But the rest of them are paying their claims right now, and will continue to pay their claims in the future. So they are the one area where we can be quite sure that mortgage risks are covered.

Mr. CAMPBELL. You know that a lot of the loss before the Fannie and Freddie—we were just talking about it earlier—at least according to their press release, they are blaming on the fact that because

PMI failed, they now have to step in and cover a lot of the private insurance.

Ms. Ratcliffe, you looked like you wanted to say something about the private insurance?

Ms. RATCLIFFE. I did want to say that, as we have talked about, the M.I.s are a sort of force to hold capital by regulatory requirements. So that does kind of prevent them from pursuing the race to the bottom.

And I think there was probably more of that, for example, in the main competitor to PMI, which was the purchase money second, those lenders really underpriced risk. And we have already talked today about the way that the private-label risk takers, mortgage-backed securities market really acted procyclically and failed to adequately price risk.

So I think those might be better examples of those procyclical tendencies than M.I., which is like government-required to reserve countercyclical.

Mr. CAMPBELL. Okay. Good point.

And then, Ms. Ratcliffe, my last question will be to you, relative to—if there is no guarantee—so we have something like the bill that is before us and we go forward—we have talked about various things that may happen, the 30-year fixed-rate mortgage could disappear.

There could be a big premium interest—the interest rates that people pay up could go up, the number of people who have the ability to get a loan could go down. There are any number of circumstances, and it could be all of those to some degree or whatever, if there were no government.

If we have no Fannie and Freddie, there is no government support for the mortgage market, it is now just this bill in place, what do you see as that doing to housing prices, to the housing market, to whatever you think it might affect?

Ms. RATCLIFFE. No, as a result of fewer mortgages being available, fewer fixed-rate mortgages being available, and costs necessarily increasing, it would obviously have a strong negative effect on the economy and on household wealth. And those obviously need to be taken into account. Moreover, I don't think that those things are necessary. I think we can—

Mr. CAMPBELL. I agree with you completely. And the other thing that all that will result in is a loss of lots and lots and lots of jobs. And when we are all debating about how to create jobs, the last thing we should be doing is putting in policies that will, without question, lose jobs. And I yield back.

Chairman GARRETT. You answered a whole bunch of different criteria as to what would happen. Did you say what would happen if, under that scenario, the government does provide the guarantee and the government prices the risk wrong? What happens then?

Ms. RATCLIFFE. I would hope we would not price the risk wrong. We have good benchmarks now for what that risk pricing should look like, and there are a number of things—government doesn't have it—always the incentive to make a profit in pricing risk.

They also don't have the same incentive to chase profits and take less risk. And we saw the FHA basically pull away from the market rather than chase it during the peak of the bubble. And so, I think there are elements about government risk-taking.

Chairman GARRETT. Just briefly, where are examples, historically, of where the government priced risks well? Is that like with blood or with the pension fund or—?

Ms. RATCLIFFE. In some of those cases, government takes risks that the private sector is not willing to take on.

Chairman GARRETT. Right, but the—

Ms. RATCLIFFE. It takes those risks in order to facilitate the functioning of some other private sector. So if you really want to look at the whole cost-benefit equation, you have to take some of those other benefits and externalities into account.

Chairman GARRETT. Yes. But at the end of the day, if they don't price the risk, who pays?

Ms. RATCLIFFE. The taxpayer. But, again, we do have pretty good markers now on what—

Chairman GARRETT. Yes.

Ms. RATCLIFFE. —crisis—what levels of capital you need to have, and what kind of pricing you would have. And that would definitely have to change from the old Fannie/Freddie.

Chairman GARRETT. I am—

Mr. CAMPBELL. Mr. Chairman, the existing bill would have the government setting underwriting standards. They might do that wrong, too. Anything the government does could potentially go wrong.

Chairman GARRETT. Right. But if that happened, who would bear the burden, then, the taxpayer or the investor?

Mr. CAMPBELL. The American economy, depending on where they set it—

Chairman GARRETT. Yes.

The gentleman from California has come back for the second round.

And the gentleman is recognized.

Mr. SHERMAN. I want to commend my colleague from California for pointing out the importance of not allowing the conforming loan limit to go down in high-cost areas. As to pricing risks, I point out that the FHA has done a good job.

CBO does a pretty good job, whether it is in the international sphere with loans to foreign countries or OPEC insurance. And the idea that the Federal Government can't price risk, CBO is a tough taskmaster, but they predict things that are just as hard to predict as downside risk. And, of course, they price risk as well.

Now, Ms. Ratcliffe, if we didn't have Fannie and Freddie, and you are the average homebuyer looking to buy a $400,000 home, how many more basis points are you going to pay? I know kind of what that answer was in 2006, back when mortgage-backed securities were very popular with the market. What are you going to pay now; any idea? And I have seen estimates of about 75 basis points. Do you have anything that would counteract that or contradict it?

Ms. RATCLIFFE. I think there is no way to know in today's marketplace what the average homebuyer would pay, if there was no form of government support in forming market at this time, maybe.

Mr. SHERMAN. Could it be more than 75 basis points?

Ms. RATCLIFFE. Certainly, depending on the borrower's characteristics, the loan amount being sought, and other—

Mr. SHERMAN. So even people who are qualifying under today's Fannie and Freddie tougher standards for a particular loan might be paying 100 to 125 basis points for that same loan?

I see the person next to you nodding his head.

Sir, do you have—?

Mr. HUGHES. I think making the argument in the extreme, that Fannie Mae drops off the face of the earth the next day, and then what are the markets going to be like is not a rational—

Mr. SHERMAN. I didn't put it forward—the extremes as if there wouldn't be a transition period and everybody would expect Fannie to exist and then the next—but let me go on with my limited time.

So what happens to home prices in this country, Ms. Ratcliffe, if—I have seen estimates that we are talking about a 15 percent to 20 percent additional decline in home prices. Do you know of anything that contradicts that?

Ms. RATCLIFFE. No, sir.

Mr. SHERMAN. And this is maybe a little outside your expertise, but it is something that Mr. Campbell and I face all the time.

What happens to the economy, particularly in places where people have so much of their life tied up in the value of their home, if we see another 15 percent or 20 percent decline? Are you aware of any studies on that?

Ms. RATCLIFFE. I am not aware of any studies. I think we have discussed some of the impacts on, obviously, jobs and household wealth.

I think one thing we haven't talked about but is worth always keeping in mind is that today we are seeing a substantial loss of wealth in housing that is going to translate, especially as people draw down on their retirement accounts and other assets to keep paying mortgages that may be underwater, that at the—this is sort of kicking the can on down the road, to make it a retirement-savings problem—

Mr. SHERMAN. And I point out, a lot of people think this only relates to folks who are looking to buy a home or looking to sell a home or looking to refinance a home.

But what I point out to people in my area is if you are just planning to continue to live in my area, and you hear that the home down the street sold for $100,000 less than everybody expected, you are not going out to dinner after that unless the restaurant has golden arches on the front of it.

So the effect on the overall economy in the San Fernando Valley of a decline in the home prices is something that affects the 90 percent of the people who aren't buying, selling or refinancing.

As to the bill, as I commented earlier today, I don't know whether this bill is just designed to assist what might remain a niche market, and that is the non-government-involved mortgage-backed securities, or whether it is the first step in taking a radical step of pushing government completely out.

So if this is just going to make the niche market more efficient, it would be hard to have any of us oppose it. But if it is the first step toward the calamity that I have discussed with Ms. Ratcliffe and others, you won't find a lot of support on this side of the aisle.

Not a whole lot of—there will be some non-supporters on your side of the aisle, too, so with that, I yield back.

Chairman GARRETT. The gentleman yields back, recognizing the calamity that we are in right now, because of the status quo of the GSEs, and the government backstop that has been provided to them.

Without objection, I will enter into the record a letter from the National Association of Federal Credit Unions; seeing none, it is so ordered.

I would like to very much thank this entire panel for all of your expert testimony and input and dialogue that we had going back, as with the first panel.

The Chair notes that some Members may have additional questions for the panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their response in the record.

And, again, I thank the panel very much. The hearing is adjourned.

[Whereupon, at 1:23 p.m., the hearing was adjourned.]

A P P E N D I X

November 3, 2011

Statement of

Edward J. DeMarco
Acting Director
Federal Housing Finance Agency

Before the U.S. House of Representatives
Subcommittee on Capital Markets, Insurance, and
Government-Sponsored Enterprises

"HR_, Private Mortgage Investment Act"

November 3, 2011

Embargoed until delivery – 10AM EDT

Statement of Edward J. DeMarco
Acting Director, Federal Housing Finance Agency
Before the U.S. House of Representatives
Subcommittee on Capital Markets, Insurance, and
Government-Sponsored Enterprises
November 3, 2011

Chairman Garrett, Ranking Member Waters and members of the Subcommittee, thank you for inviting me this morning to discuss Chairman Garrett's recent legislative proposal ("Discussion Draft") to reform the secondary mortgage market. I am pleased that the Subcommittee is beginning the serious work of considering housing finance reform options, which will lead to the ultimate resolution of Fannie Mae and Freddie Mac (the Enterprises).

This morning I will briefly review the work of the Federal Housing Finance Agency (FHFA) since I last appeared before the Subcommittee in May and then I will address housing finance reform issues, including the Chairman's proposal.

FHFA INITIATIVES

The Enterprises cannot operate indefinitely in conservatorship, and I look forward to further consideration of housing finance reform options. However, as long as FHFA remains conservator and regulator for the Enterprises, our activities will continue to be guided by the three principal statutory mandates set forth in law. Our mandates, simply stated, are: to preserve and conserve Enterprise assets and place the Enterprises in a sound and solvent condition; to support a stable and liquid mortgage market; and to maximize assistance to homeowners to minimize foreclosures. As FHFA has noted on numerous occasions, with taxpayers providing the capital supporting the Enterprises' operations the "preserve and conserve" mandate directs us to minimize losses on behalf of taxpayers.

I will very briefly highlight some of the key conservatorship activities we have taken to support one or more of our mandates since I last addressed this Subcommittee six months ago.

Lawsuits

Consistent with FHFA's mission to preserve and conserve the Enterprises' assets on behalf of the taxpayer, this year we filed lawsuits against 18 financial institutions to recover losses suffered by Freddie Mac and Fannie Mae. FHFA is seeking compensatory damages for losses the Enterprises incurred on private-label securities due to misrepresentations and other improper actions by the firms and individuals named in the suit. We believe that the loans had different and more risky characteristics than the descriptions contained in the marketing and sales materials provided to the Enterprises for those securities.

REO – RFI

In August, FHFA in conjunction with the Department of Housing and Urban Development (HUD) and the Treasury Department, issued a Request for Information (RFI) seeking input on new options for selling single family real estate owned (REO) held by Freddie Mac, Fannie Mae, and FHA. We are looking for approaches to reduce the REO portfolios of the Enterprises in a cost-effective manner, as well as to reduce the losses on individual distressed properties. We are looking for alternatives that will maximize value to taxpayers and increase private investments in the housing market, including approaches that support rental and affordable housing needs. We are not looking to develop a single, national program for REO disposition. We are most interested in proposals tailored to the needs and economic conditions of local communities. We received nearly 4,000 responses to the RFI and are reviewing the submissions.

Servicing Alignment Initiative

Our Servicing Alignment Initiative (SAI), which we announced last April, responded to concerns about how delinquent mortgages were being serviced. SAI meets the conservatorship objectives of minimizing losses and assisting homeowners with alternatives to foreclosure. FHFA instructed Freddie Mac and Fannie Mae to establish a single, consistent set of procedures for servicing Enterprise mortgages, from the time they first become delinquent. The updated framework, which went into effect on October 1, prioritizes early borrower outreach, streamlines documentation requirements, simplifies mortgage modification terms and requirements, and establishes a schedule of performance-based incentive payments and penalties aimed at ensuring that servicers review foreclosure alternatives in a timely manner. We are also working to align and improve Fannie Mae and Freddie Mac policies regarding unemployment forbearance to reflect the realities of the current job market.

Foreclosure Attorney Networks

Last month, as an adjunct to SAI, FHFA directed Freddie Mac and Fannie Mae to change the way foreclosure attorneys are selected in an effort to produce uniform foreclosure processing standards to assist servicers, homeowners, and lenders. Under current practice, in certain states each Enterprise designates law firms eligible under the Enterprise's criteria to undertake foreclosure work and mortgage servicers then select and work with these firms.

FHFA instructed Fannie Mae and Freddie Mac to transition away from current foreclosure attorney network programs and move to a system where mortgage servicers select qualified law firms that meet certain minimum, uniform criteria. These efforts will lead to greater transparency and benefit delinquent borrowers who become subject to the foreclosure process. FHFA is now working with other industry stakeholders to create uniform qualifications and oversight of foreclosure attorneys.

I am hopeful that these new directives that create uniform procedures for servicing delinquent loans and processing foreclosures will gain acceptance beyond the Enterprises and be used as "best practices" throughout the industry.

HARP

On October 24, we announced a series of changes we are making to the Home Affordable Refinance Program (HARP). These changes should make HARP refinances accessible to more households with mortgages owned or guaranteed by the Enterprises. Changes to the program include: eliminating or reducing certain risk-based fees; removing the current 125 percent LTV ceiling; waiving certain representations and warranties; eliminating the need for certain property appraisals; carrying over mortgage insurance coverage; and extending the end date for HARP until December 31, 2013.

Importantly, such refinances should also reduce the Enterprises' credit risk, and thus losses to taxpayers. HARP, even with the new enhancements, is not a mass refinancing program; it was designed to help a defined set of borrowers with Fannie Mae and Freddie Mac mortgages that are underwater or nearly underwater.

It is impossible to project accurately how many homeowners will benefit from the enhancements to HARP because of unknowable factors, such as future interest rate fluctuations. Since HARP was introduced in 2009, almost 900,000 homeowners have refinanced through the HARP program. We believe the changes announced last week may help double the number of homeowners helped through HARP.

The Enterprises plan to issue guidance with operational details about the HARP changes to mortgage lenders and servicers by November 15. Since industry participation in HARP is not mandatory, implementation schedules will vary as individual lenders, mortgage insurers and other market participants modify their processes.

Servicing Compensation Initiative

The last initiative I will discuss today, the Joint Servicing Compensation Initiative, made up of FHFA, Fannie Mae, Freddie Mac, and HUD, is one of the initiatives we have directed the Enterprises to undertake that are designed to broadly consider changes that will lead to improvements in the operations of the Enterprises and the overall mortgage market. The goals of the Joint Initiative are to improve service for borrowers, reduce financial risk to servicers, and provide flexibility for guarantors to better manage non-performing loans, while promoting continued liquidity in the To Be Announced mortgage securities market. In addition to those specific goals, the Joint Initiative seeks broader options for mortgage servicing compensation that lead to enhanced competition in mortgage servicing and origination, and that can be replicated across multiple future states of housing finance.

At the end of September, the Joint Initiative released a discussion document seeking comments on two alternative servicing compensation structures for servicing single-family mortgages. One proposal would establish a reserve account within the current servicing compensation structure. The other proposal would create a new Fee for Service compensation structure. We requested that comments be submitted by late December, after which they will be considered and evaluated by the Joint Initiative.

Let me now turn to my thoughts about reforming the housing finance system in this country, including comments on the Discussion Draft.

HOUSING FINANCE REFORM

The decision to place the Enterprises into conservatorship proved to be appropriate, accomplishing the Federal government's primary objective of supporting the ongoing availability of mortgage financing during a period of severe market contraction. The actions of placing the Enterprises into conservatorship, along with the financial support provided by the Treasury Department, were designed to maintain stability while providing policymakers time to consider the appropriate course for housing finance reform and the transition from the current Enterprise structure. Despite the benefits derived from the Treasury support for Enterprises activities, conservatorship is not a long-term solution.

We just passed the three-year anniversary of placing the Enterprises into conservatorship. We all knew it was going to be difficult to develop a housing finance reform solution, but we must move forward on this process. As the conservatorships lengthen, FHFA must not only direct the Enterprises' activities on various programs consistent with our conservatorship mandates, but must also consider how the Enterprises should be structured and make investments in business platforms and human capital in the face of an uncertain future.

In thinking about the goals of a future housing finance system, I would start by reiterating the objectives that I shared with this Subcommittee last year. Our main purpose in addressing housing finance reform should be to promote the efficient provision of credit to finance mortgages for single-family and multifamily housing. I believe that an efficient system of credit allocation should have certain core characteristics: allowing innovation, providing consumer choice, providing consumer protection, and facilitating transparency.

While these characteristics provide a set of goals for the future of the housing finance system, there are a number of specific areas related to the current activities of the Enterprises that deserve special attention, which include:

- ensuring that the mortgage market has adequate sources of liquidity;
- having the ability to avoid and if necessary absorb credit risk; and
- promoting the availability of mortgage credit.

To state the obvious, the key question in the debate on housing finance reform is the future role of the government in achieving these objectives.

We should be clear about this question at the outset. It seems safe to say that there will always be some portion of the housing or mortgage market that will be assisted by government programs, either through direct funding or through guarantees. In the future design of our housing finance system, careful consideration should be given to targeting subsidies to specific groups that lawmakers determine warrant that benefit. For example, the explicit government guarantees that the Federal Housing Administration and Veterans Administration provide reflect policymakers' judgment as to the public benefits from targeting certain borrowers with those programs. This is also the case through other programs provided by the Department of Housing and Urban Development.

Acknowledging that there will be a role for the government in the above areas, a further refinement of the key question regarding the government's role in housing finance is what type of structure is necessary to replace the activities that are currently undertaken by the Enterprises. There seems to be relatively broad agreement that the government sponsored enterprise model of the past, where private sector companies were provided certain benefits and charged with achieving certain public policy goals, did not work. That model relied on investors providing funding for housing at preferential rates based on a perception of government support, which ultimately turned out to be correct and has resulted in Enterprises' drawing $169 billion in funds from Treasury as of September 30, 2011.

Several proposals have been put forth on developing a housing finance system with some type of government guarantee. Clearly if the securities offered in a reformed housing finance market have a government guarantee, those securities will be priced favorably and have a high degree of liquidity to reflect that guarantee. However, those securities would not have the benefit of market pricing for credit risk of the underlying mortgages. In these structures, much like the banking system and deposit insurance, private sector capital through equity investment would stand in a first loss position, with a government guarantee that was funded through an insurance premium being available to cover other losses. This type of structure requires a significant amount of regulatory safety and soundness oversight to protect against the moral hazard associated with providing a government guarantee.

While such an outcome has certain merit and some attractive features, the potential costs and risks associated with such a framework should be fully explored. To put it simply, replacing the Enterprises' implicit guarantee with an explicit one does not resolve all the shortcomings and inherent conflicts in that model, and it may produce its own problems. Last year before this Subcommittee I offered three observations in that regard for your consideration.

First, the presumption behind the need for an explicit Federal guarantee is that the market either cannot evaluate and price the tail risk of mortgage default, at least at any price that most would consider reasonable, or cannot manage that amount of mortgage credit risk on its own. But we might ask whether there is reason to believe that the government will do better? If the government backstop is underpriced, taxpayers eventually may foot the bill again.

Second, if the government provides explicit credit support for the vast majority of mortgages in this country, it would likely want a say with regard to the allocation or pricing of mortgage credit for particular groups or geographic areas. The potential distortion of the pricing of credit risk from such government involvement risks further taxpayer involvement if things do not work out as hoped.

Third, regardless of any particular government allocation or pricing initiatives, explicit credit support for all but a small portion of mortgages, on top of the existing tax deductibility of mortgage interest, would further direct our nation's investment dollars toward housing. A task for lawmakers is to weigh such incentives against the alternative uses of such funds.

CHAIRMAN GARRETT'S DISCUSSION DRAFT

Another approach, as set forth in the Discussion Draft is to establish a functioning mortgage-backed securities market through replacing some of the standard-setting that the Enterprises undertake today with a regulatory regime that sets those standards. This model would not rely on a government guarantee to attract funding to the mortgage market, but rather would look to standardization and rules for enforcing contracts to provide a degree of certainty to investors.

While we have not had time to fully evaluate the Discussion Draft, the focus is on setting standards around key features that investors need to know to be willing to price credit risk in the mortgage market. These include standards associated with: underwriting; pooling and servicing; and disclosures. The model proposed in the Discussion Draft also tries to preserve some of the liquidity in today's mortgage-backed securities market by establishing buckets of securities that have similar credit characteristics and loan terms.

Clearly the framework envisioned in the Discussion Draft is much different than a framework that has a government guarantee. Investors would be required to price the credit risk of mortgages. They also would be responsible for enforcing their rights under the standard contracts developed under this framework. Those requirements are consistent with the way that a private market functions.

We look forward to further considering the framework set forth in the Discussion Draft. Some areas that deserve further consideration include the following:

- Standardization will help to develop a private mortgage-backed securities market. Are there other areas in terms of monitoring or compliance that could potentially broaden the investor base while still achieving the primary function of having private markets price credit risk?
- Preserving the availability of credit in times of stress is an important function. Is there a role for the government, perhaps through the Federal Housing Administration to take on this role if necessary?
- Preserving liquidity in the market and the financial system in this framework would be an important function. Is there a need for a backstop source of funding when financial markets become temporarily illiquid? For example, could the Treasury Department, the Federal Reserve or the Federal Home Loan Banks play a role in a market that had this type of standardized structure?

These are just some of the issues that will have to be thought through as the process moves forward on building out this framework.

The process of undertaking housing finance reform is difficult. The Discussion Draft is a thoughtful approach to a framework that does not rely on a government guarantee. The final decision that policymakers must make involves determining what structure will provide a functioning housing finance market and does not place taxpayers at risk.

CONCLUSION

Mr. Chairman, I would like to thank you for helping to move the housing finance reform discussion forward by holding this hearing. I believe that private capital markets can and should reclaim a prominent portion in providing housing finance, and your legislative proposal broadens the discussion of how we might do that.

I recognize this Subcommittee has difficult and important decisions to make in the coming months and FHFA looks forward to offering technical assistance to both the Administration and Congress in considering policy alternatives.

American SECURITIZATION FORUM®

Statement of:

Tom Deutsch
Executive Director
American Securitization Forum

Testimony before the:

Committee on Financial Services
Capital Markets and Government Sponsored Enterprises Subcommittee
United States House of Representatives

Hearing on:

H.R. _____, the Private Mortgage Market Investment Act

November 3, 2011

One World Financial Center, 30th Floor • New York, NY 10281-0006 • 212.412.7100
Columbia Center • 1152 15th Street, N.W., Suite 100 • Washington, D.C. 20005-1706 • 202.400.3600
www.americansecuritization.com

ASF Testimony
H.R. _____, the Private Mortgage Market Investment Act
November 3, 2011

TABLE OF CONTENTS

Chairman Garrett, Ranking Member Waters and distinguished Members of the Subcommittee, my name is Tom Deutsch and as the Executive Director of the American Securitization Forum (the "ASF")[1], I very much appreciate the opportunity to testify here regarding the proposed Private Mortgage Market Investment Act on behalf of the 330 ASF institutions who originate, structure, trade, service, invest[2] and serve as trustee for the preponderance of residential mortgage-backed securities ("RMBS") created in the United States, including those backed entirely by private capital as well as those guaranteed by public entities such as Fannie Mae, Freddie Mac and Ginnie Mae (for the purposes of this testimony, collectively, the "Government-Sponsored Enterprises" or "GSEs").

I. Introduction

Let me begin my remarks by stating what I believe to be a near consensus proposition—there is very strong political and economic will in the United States today to decrease the overall level of federal government involvement in housing finance, and to have more private capital eventually replace many of the risks and rewards of that involvement. Given that 90+% of mortgage loans made in America in the first half of 2011 were guaranteed by the GSEs, there certainly isn't a shortage of opportunity to achieve this goal. The value of the U.S. housing stock is an estimated $16.1 trillion with an estimated $9.75 trillion of single-family home mortgage

[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. The ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. More information regarding the ASF can be found at www.americansecuritization.com.

[2] The vast majority of investors in the securitization market are institutional investors, including banks, insurance companies, mutual funds, money market funds, pension funds, hedge funds and other large pools of capital. Although these direct market participants are institutions, many of them—pension funds, mutual funds and insurance companies, in particular—invest on behalf of individuals, in addition to other account holders.

loans outstanding.[3] There are approximately 55 million first lien mortgages outstanding in the United States today and an additional 25 million homes that have no mortgage attached to them. Approximately $7 trillion dollars of outstanding mortgage debt resides in securitization trusts and are beneficially owned by institutional investors around the world. Approximately $5.5 trillion dollars of these loans are government-guaranteed in GSE RMBS, with an additional $1.5 trillion in outstanding private-label RMBS that have no government backstop. An additional $2.75 trillion dollars of mortgage debt is owned in the portfolios of commercial banks, savings institutions and insurance companies. In addition to the $9.75 trillion of outstanding first lien mortgages, approximately $1 trillion of second liens are currently outstanding in the United States.[4]

To date though, Fannie Mae and Freddie Mac have drawn $169 billion in support from the American taxpayer through the Department of the Treasury since they were placed under conservatorship and are predicted by the Federal Housing Finance Agency ("FHFA") to draw a total ranging from $220 billion to $311 billion by the end of 2014.[5] Few, if any, mortgage market participants expect Fannie or Freddie to be able to repay any material portion of those draws. Given these substantial losses and the outsized role of the GSEs in today's U.S. mortgage finance system, ASF's membership believes that there is a clear need to reduce the federal government role in securitization going forward. While there is little opportunity for an overnight transition, there is a strong need to begin that transition as soon as possible to rework

---

[3] B.100 Balance Sheet of Households and Nonprofit Organizations from Federal Reserve Z.1 Statistical Release for the Second Quarter for 2011.
[4] Data compiled by Amherst Securities, based on information from the Federal Reserve Flow of Funds, Fannie Mae, Freddie Mac, Ginnie Mae and CoreLogic.
[5] See the FHFA's October 2011 report, "Projections of the Enterprises' Financial Performance," at http://www.fhfa.gov/webfiles/22737/GSEProjF.pdf.

and restore long-term health to the capital markets for mortgages and the broader housing market.

Reducing dependence on public guarantees for new mortgage origination necessarily implies that private capital investment in mortgage originations will have to be reinvigorated. Securitization is an absolutely essential funding mechanism for this to occur, as evidenced by observing the significant proportion of consumer credit it has financed in the U.S. in the last few decades. Securitization generally refers to the process by which consumer and business assets are pooled into securities that are issued and sold into the capital markets. The payments on those securities depend primarily on the performance of the underlying assets. Over the past 25 years, securitization has grown from a relatively small and unknown segment of the financial markets to a mainstream source of credit and financing for individuals and businesses, representing a vital sector of the financial markets.[6] It is estimated that securitization has funded between 30% and 75% of lending in various markets, including an estimated 59% of outstanding home mortgages, as of 2008.[7]

Although large and small bank portfolios have continued to help fund some level of mortgage origination outside of the GSE business, that level has not been sufficient to meet overall consumer demand and reinvigorate the housing market. Securitization is critical to bank balance sheets; therefore, in light of capital and liquidity constraints currently confronting financial institutions and markets globally, restoration of function and confidence to the

---

[6] For more information on the role and importance of securitization to the financial system and US economy, see ASF Reg AB II Comment Letter, Attachment II, pg. 143-147 (August 2010), available at http://www.americansecuritization.com/uploadedFiles/ASFRegABIICommentLetter8.2.10.pdf.

[7] Citigroup, "Does the World Need Securitization?" pg. 10-11 (Dec. 2008), available at http://www.americansecuritization.com/uploadedFiles/Citi121208_restart_securitization.pdf.

securitization markets is a particularly urgent need. With the process of bank de-leveraging and balance sheet reduction still underway, and with increased bank capital requirements on the horizon, such as those expected in Basel III, the funding capacity provided by securitization cannot be replaced with deposit-based financing alone in the current or foreseeable economic environments. In fact, the International Monetary Fund ("IMF") estimated that a financing "gap" of $440 billion existed between total U.S. credit capacity available for the nonfinancial sector and U.S. total credit demand from that sector for the year 2009.[8] Although key legislative initiatives such as covered bonds[9] may help extend the balance sheets of banks to fund additional mortgages, there will still be outer limits of bank risk and capital that constrain the availability of needed mortgage and consumer credit.

Since the rapid deflation of the housing bubble starting in 2007, many individuals have asked whether market participants would support eliminating the government guarantee over an extended period of time, and ultimately what the mortgage market would look like without a guarantee. This is an extremely difficult, if not impossible, question to answer without some initial evolution in the mortgage system. Because the U.S. mortgage market has grown up for nearly a century around the presence of a government guarantee, breaking down institutional buildup and rebuilding investor demand in new products will take time. But a mortgage market where 90+% percent of all mortgages currently originated have some form of government support is neither sustainable nor desirable, and Congress must take steps to substantially reduce the government's role in mortgage finance. This must be done responsibly so that greater

[8] International Monetary Fund, "The Road to Recovery." Global Financial Stability Report: Navigating the Financial Challenges Ahead (Oct. 2009), pg. 29, available at http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf.
[9] For ASF's March 11, 2011 testimony before the House Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises regarding covered bonds legislation, see http://www.americansecuritization.com/uploadedFiles/ASF_HFSC_Covered_Bond_Testimony_3_11_11.pdf.

dislocation doesn't occur within our nation's fragile housing market. There are many aspects of Chairman Garrett's legislation that work toward this goal and that ASF supports, particularly with respect to appropriate standardization and ensuring respect and clarity for applicable laws. We appreciate the opportunity today to discuss some of the key details of this proposal.

II. Transitional Concerns Related to the GSEs

Getting from our current state of the GSEs to some future state will require some appreciable time measured in years for the transition. The length of time of this transition may vary widely depending on how dramatic that transformation is and how the existing assets and infrastructure of the GSEs are used.[10]

Increasing guarantee fees through legislation such as H.R. 1222 proposed this spring by Congressman Neugebauer and the reduction in conforming loan limits that just occurred at the end of September represent two specific shorter term mechanisms through which to reduce this reliance. These guarantee fees are charged by the GSEs to lenders as compensation for servicing, selling, guaranteeing, and providing information on the underlying loans. Last September, the FHFA released its annual report on guarantee fees, which found that the pricing of these fees often subsidizes the GSEs' guarantees on some single-family mortgages.[11] Therefore, raising these fees will serve to encourage fairer competition with the private sector. Additionally, reducing conforming loan limits can serve to decrease reliance on the GSEs, as fewer properties will qualify for the lower interest rates on conforming mortgages backed by a federal guarantee, thereby also increasing competition with the private market.

[10] For additional information on ASF's views on transition and guarantee issues, please see ASF's September 2010 testimony at http://www.americansecuritization.com/uploadedFiles/ASF_HFSC_Testimony_09.29.10.pdf.
[11] For the FHFA report, see www.fhfa.gov/webfiles/22642/2011GFeeReportFinal.pdf.

III. Key Reasons for Lack of Private Securitizations

A. Death by a Thousand Regulatory Cuts

While ASF is generally supportive of many individual securitization market regulatory reform initiatives, we believe that it is important to consider the overwhelming volume and cost of these initiatives to market participants when set forth simultaneously. In addition to the significant burdens posed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") risk retention requirements and the Bureau of Consumer Financial Protection's ("CFPB") qualified mortgage ("QM") regulation, discussed below, the RMBS and consumer asset-backed securities ("ABS") market is currently facing a barrage of regulatory initiatives from the Securities and Exchange Commission ("SEC"), Federal Deposit Insurance Corporation ("FDIC"), Board of Governors of the Federal Reserve System ("FRB"), and Commodity Futures Trading Commission ("CFTC"), as well as from the radical rework of risk-based capital requirements under Basel III. Attachment A of this testimony provides a dizzying visual representation of the number of regulatory initiatives currently challenging the restart of the securitization market. The large number and high cost of these regulatory initiatives threatens ongoing paralysis of the securitization market, as many current market participants and potential new entrants are choosing to sit on the sidelines while policymakers take years to reform the size and shape of the full regulatory scheme. Even more concerning, given the size of the housing finance market, it is difficult to see how the broader U.S. economy can significantly improve until uncertainties around these issues are resolved and securitization returns. In our May, 2011 U.S Senate testimony, we articulated many of the most pressing regulatory issues currently confronting the securitization industry.[12] But even since May, a number of additional policy initiatives[13] have been proposed that will further weigh on the industry or even crush some sectors or subsets of the securitization markets, including:

- Volcker Rule
- Conflicts of Interest
- Basel 2.5 and III
- Rating Agency Reform
- Regulation AB II ("Reg AB II") Proposals and Re-Proposals
- Regulation of Derivatives

In addition to the issues listed above, there are a number of other impediments to private capital returning to the residential mortgage market. First, the GSEs continue to subsidize the vast majority of the residential mortgage market, and therefore maintain a substantial competitive advantage by under-pricing credit risk. Second, banks are utilizing deposits as a very low-cost way to fund residential mortgages on balance sheet, making it a better execution method than securitization. Finally, many investors that invested during the crisis have been slow in returning, and have demanded greater yield in order to participate in this space.

---

[12] See testimony of ASF Executive Director Tom Deutsch delivered to the Senate Committee on Banking, Housing, and Urban Affairs ("SBC") Subcommittee on Securities, Insurance, and Investment ("Securities Subcommittee") on May 18, 2011, available at: http://www.americansecuritization.com/uploadedFiles/ASF_Senate_Banking_Securitization_Testimony_5-18-11.pdf.

[13] Additional summary information on ASF's concerns related to these proposals may be found at: http://www.americansecuritization.com/uploadedFiles/New_Regulatory_Initiatives.pdf.

IV. Discussion of H.R. ____, the "Private Mortgage Market Investment Act"

A. Standardization

i. Replication of Existing TBA Market

The first key goal of Chairman Garrett's legislation appears to be to increase standardization and uniformity within the secondary mortgage market by, among other things, requiring the FHFA to prescribe uniform underwriting standards. These standards would attempt to replicate much of the liquidity function of the so-called "To-Be-Announced" ("TBA") market. There shouldn't be any underestimation of the importance of maintaining the TBA market. Although not well understood outside the housing finance industry, the TBA market makes it possible for borrowers to have the peace of mind of locking in favorable mortgage rates and originators' immediate and liquid sale in the capital markets. A TBA is a contract for the purchase or sale of GSE MBS (e.g., $50 million Fannie Mae 5.5% MBS in December) to be delivered at a future, specified date, sometimes substantially (up to 90 days) in advance of the settlement date. For a variety of reasons discussed more fully in ASF's comment letter submitted last summer to the Departments of Treasury and Housing and Urban Development in response to the July 21, 2010 request of those Departments,[14] there are significant challenges to replicate a TBA market outside of the GSEs.

The TBA market is possible for two reasons: first, the fungibility of the conforming loan product, which is a standardized product with established and uniform underwriting guidelines and form documentation, and, second, the effect of the GSE guaranty, which serves to equilibrate

[14] See http://www.americansecuritization.com/uploadedFiles/ASFGSEReformCommentLettertoTreasury-7.21.10.pdf

credit risk of all of the securitized MBS. It is the guarantee function that attracts so-called "rates investors" because of the absence of underlying credit risk within the securities.

For a variety of reasons, it is difficult to replicate a TBA market outside of the GSEs, though not necessarily impossible in the long-term. Although certain solutions may be appropriate and necessary for the overall health of the residential mortgage system, they pose unique challenges for the current TBA market. For a more fulsome discussion of these highly technical and detailed matters, I direct your attention to the July 21, 2010 ASF comment letter referenced above, but as issues related to managing forward interest rate risk, an originator of a mortgage loan that is intended for inclusion in a private label RMBS has typically protected itself from market interest rate changes between origination and securitization by various mechanisms, which have included, for example: 1) a commitment to purchase that loan at a set price from the entity that intends to sponsor the securitization, or 2) an interest rate hedge, if the originator will be the sponsor or is otherwise exposed to market interest rate risk. While these types of mechanisms have their cost and effectiveness limitations (it is frequently said that there is no such thing as a perfect hedge), these types of mechanisms that have been used in the past should be sufficient to protect originators from interest rate risk on a going forward basis as the private label RMBS markets recover.

Before I move on, however, I must point out that any reform of the GSEs which does not accommodate, or suitably replace, the existing GSE MBS TBA market will undoubtedly impact mortgage originators and borrowers both severely and negatively.

ii. Securities Act Registration Exemption

If the ultimate bill includes a mandate for a waiting period and loan-level disclosure for all registered MBS (or if the SEC's Reg AB II proposals are enacted), any attempt to emulate the TBA offering process would have to include an exemption from registration. The furnishing of enhanced loan-level data to investors is inconsistent with the operation of the TBA market. A forward market cannot have true loan-level disclosure, because the loans have not actually been identified as of the trade date and subsequently delivering loans conforming to a set of exacting criteria, such as the SEC's Reg AB II loan-level fields, would not be possible. Even if ranges were included to aid an issuer's ability to deliver conforming loans, investors would have to assume the bottom of the range would ultimately be included in the pool. A five day waiting period would also be inconsistent with the current construct of the TBA market, because additional time is generally not necessary to evaluate assets that are truly fungible.

iii. FHFA as Private-Label Standard Setter

As stated previously, the Garrett legislation contemplates the FHFA to establish uniform underwriting standards. There are clearly advantages and disadvantages to having the FHFA, or any other government agency, set these standards. A clear advantage is that bright-line underwriting standards will bring additional clarity and certainty with respect to the underwriting of mortgage loans. However, we have concerns with government involvement in setting underwriting criteria as it could, over time, become susceptible to political interference, such as pressure to achieve increased homeownership in particular segments of the country or access to credit for certain borrowers. If the goal of the legislation is to promote robust private capital without government involvement, then it may be advisable to move some of the standard-setting process to private market participants or leave it to evolving market practice. This could be accomplished in a variety of different ways, including a "standards board" comprised of issuers and investors.

B. Alignment of Incentives

During the recent economic crisis, some commentators questioned whether mortgage loan originators adequately mitigated or retained sufficient risk in the loans they were making to borrowers, especially when those loans were sold into securitization trusts. These critics pointed to a lack of "skin in the game," which they believe misaligned incentives between originators and investors and failed to ensure the loans underlying were of adequate credit quality.

ASF supports efforts to align the incentives of issuers and originators with investors of ABS and we believe these incentives should encourage the application of sound underwriting standards by both the originator and securitizer in connection with the assets that are securitized. ASF began the process to better align incentives over three years ago, when we launched our Project on Residential Securitization Transparency and Reporting ("Project RESTART"),[15] which is a broad-based industry-developed initiative to help rebuild investor confidence in mortgage-backed securities. It has been recognized by senior policymakers and market participants as a necessary industry initiative to improve the securitization process by developing commonly accepted and detailed standards for transparency, disclosure and diligence that each

---

[15] For more information on ASF Project RESTART, see http://www.americansecuritization.com/restart.

appropriate market participant will be recommended to implement.[16] As part of this effort, ASF developed a set of model representations and warranties (the "ASF Model Reps")[17] aimed at infusing transparency and comparability across securitization transactions and a set of RMBS repurchase principles (the "ASF Repurchase Principles")[18] for investigating, resolving and enforcing remedies with respect to representations and warranties in RMBS transactions involving newly originated mortgage loans. These two initiatives combine to create a very strong alignment of incentives between issuers and investors in RMBS transactions and are flexible enough to allow for appropriate changes in the market over time. As part of Dodd-Frank, Congress also decided to address alignment of incentives, but opted to employ credit risk retention and tasked a team of regulators (the "Joint Regulators") with implementing regulations that would effect "skin in the game," but still permit appropriate access to credit.

While ASF believes that appropriate risk retention rules can aid in achieving a proper alignment of incentives, we believe it is far more critical that "skin in the game" be implemented for future RMBS transactions through appropriate representations and warranties coupled with an effective repurchase mechanism. We also believe that the rules proposed by the Joint

[16] In its March 2008 Policy Statement on Financial Market Developments, the President's Working Group (the "PWG") on the Financial Markets recommended that ASF develop templates for disclosure in securitization that support efforts to improve market discipline and on June 24, 2008, Acting Under Secretary for Domestic Finance Anthony W. Ryan announced that the PWG had engaged ASF as the private sector group to develop best practices regarding disclosure to investors in securitized credits. Most recently, Fed Governor Sarah Bloom Raskin commended ASF's Model Reps and Repurchase Principles in an October 4, 2011 speech. See http://www.treasury.gov/resource-center/fin-mkts/Documents/pwgpolicystatemktturmoil_03122008.pdf, http://www.treasury.gov/press-center/press-releases/Pages/hp1053.aspx, and http://www.federalreserve.gov/newsevents/speech/raskin20111004a.htm.

[17] See http://www.americansecuritization.com/uploadedFiles/ASF_Project_RESTART_Reps_and_Warranties_121509.pdf.

[18] See http://www.americansecuritization.com/uploadedFiles/ASF_Model_RMBS_Repurchase_Principles.pdf.

Regulators[19] are not sufficiently tailored to the various asset classes that are securitized and will likely cause a host of negative unintended consequences, some of which are described below.

i. ASF Concerns with Proposed Risk Retention Rules

In drafting the proposed rules, the Joint Regulators indicated that they had taken into account the diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which securitizers may have retained risk. Despite those efforts, substantial work still needs to be done to evolve the proposed risk retention rules into workable solutions that will not inhibit securitization. What is at stake is the risk of significant reductions in the availability of auto loans, mortgages, student loans, credit cards, and commercial credit all across America. Given that many engines of the U.S. economy are still sputtering and unemployment remains extremely high, ASF advocates strongly that these rules not overreach to attempt to "fix" sectors of the securitization markets that did not see any losses during an extreme economic downturn and instead are now powering economic revival in some areas of the economy. Attempts to realign incentives in many types of securitization structures, where those incentives have demonstrated through strong performance to be well-aligned between issuer and investor, only serve to risk harm to the American economy, consumers and investors.

The proposed risk retention rules create such a risk to the securitization market that some have advocated the concept be eliminated altogether. In fact, Chairman Garrett's proposed bill would strike the risk retention provisions of Dodd-Frank, rendering the proposed rules moot.

[19] See http://www.sec.gov/rules/proposed/2011/34-64148.pdf.

ASF believes that our substantial comments to the Joint Regulators should enable them to revise the proposed risk retention rules to tailor the provisions to the various asset classes in order to promote a healthy securitization market. However, if the Joint Regulators were unable or unwilling to implement a substantial portion of our recommendations to allow many MBS and ABS to continue forward, ASF would likely endorse the outright removal of risk retention from Dodd-Frank.

a. ASF's Previous Comments on Risk Retention

In an effort to ensure that risk retention is implemented properly, ASF has submitted hundreds of pages of comments including: (i) a series of preliminary comment letters last year supporting the proposal of risk retention requirements that are tailored to each major asset class, including RMBS, auto ABS, asset-backed commercial paper ("ABCP"), credit card ABS, student loan ABS and corporate debt repackagings; (ii) a comprehensive comment letter in response to the Joint Regulators' proposed risk retention rules; and (iii) a supplemental comment letter addressing the proposed "qualifying automobile loan" exemption.[20] Additionally, ASF previously delivered its views on this subject to Congress during a hearing of the House Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises entitled, "Understanding the Implications and Consequences of the Proposed Rule on

---

[20] For more information on ASF's risk retention advocacy and the preliminary comment letters, see http://www.americansecuritization.com/story.aspx?id=4884, for our comprehensive comment letter, see http://www.americansecuritization.com/uploadedFiles/ASF_Risk_Retention_Comment_Letter.pdf, and for our supplemental comment letter addressing the "qualifying automobile loan," see http://www.americansecuritization.com/uploadedFiles/ASF_Auto_QAL_Comment_Letter_8_1_11.pdf.

Risk Retention"[21] and a subsequent hearing of the Senate Banking Committee's Subcommittee on Securities, Insurance & Investment entitled, "The State of the Securitization Markets."[22]

In these comment letters and testimony, our membership sought to highlight the intricacies of each asset class and stress the need for risk retention requirements that are tailored to each class of securitized assets. These views are consistent with Dodd-Frank's directive to implement "separate rules for securitizers of different classes of assets" and reflect the primary recommendation of both the Board of Governors of the Federal Reserve System in its October 2010 Report on Risk Retention[23] and the Financial Stability Oversight Council, chaired by Treasury Secretary Timothy F. Geithner, in its January 2011 study.[24]

We believe that the proposed risk retention rules missed the mark in many key areas and failed to achieve the recommendations of the risk retention studies mandated by Dodd-Frank. In particular, there are areas within the proposed risk retention rules that will greatly inhibit a healthy private securitization market, particularly with respect to residential mortgages, and for these reasons, we continue to believe that a re-proposal is necessary to ensure that the Joint Regulators get the final risk retention rules right. We highlight the areas of greatest concern below.

---

[21] See "ASF Risk Retention Testimony Before HFSC," American Securitization Forum (April 14, 2011), available at http://www.americansecuritization.com/uploadedFiles/ASF_HFSC_Risk_Retention_Testimony_4-14-11.pdf.

[22] See "ASF Senate Banking Testimony," American Securitization Forum (May 18, 2011), available at http://www.americansecuritization.com/uploadedFiles/ASF_Senate_Banking_Securitization_Testimony_5-18-11.pdf.

[23] See http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf, pg. 3, 83-84. "In light of the heterogeneity of asset classes and securitization structures, practices and performance, the Board recommends that rulemakers consider crafting credit risk retention requirements that are tailored to each major class of securitized assets."

[24] See the FSOC Study, pg. 3, available at: http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20%28FINAL%29.pdf. A risk retention framework should "[a]lign incentives without changing the basic structure and objectives of securitization transactions; [p]reserve flexibility as markets and circumstances evolve; and [a]llow a broad range of participants to continue to engage in lending activities, while doing so in a safe and sound manner."

b. Premium Capture Will Greatly Inhibit Mortgage Securitization

The proposed premium capture rule exceeds the mandate and legislative intent of Dodd-Frank by adding on to the 5% risk retention requirement the entire value of ABS issued in a securitization over par—effectively nullifying the securitizer's entire return and recoupment of costs associated with the transaction. The rule as proposed will have pervasive effects on securitization and borrowers, including assuring the accounting consolidation of the securitization onto the balance sheet of the securitizer regardless of the risk retention form employed, effectively making securitization another form of balance sheet lending, which as noted above, is incapable of supporting the housing market. In Section VIII.A.vi.b. of our comprehensive risk retention comment letter, we describe a hypothetical securitization of a single loan and explain how the cost associated with premium capture would result in the loan's interest rate being approximately 2.00% higher, and its monthly payment being approximately 24% higher, than would otherwise be the case. This is consistent with recent research done by Mark Zandi, Chief Economist of Moody's Analytics, who stated that "[a]s a result of the way the premium capture rule is stated, the mortgage rate impact to borrowers would be significant—on the order of an increase of 1 to 4 percentage points depending on the parameters of the mortgages being originated and the discount rates applied."[25]

The premium capture rule also fails to take into account the cost of origination of loans, including out-of-pocket costs such as appraisals and title insurance, as well as the originator's overhead and profit on sale. In addition, the rule would interfere with an originator's or sponsor's ability to use interest rate hedges during the period between origination and

[25] See http://www.americansecuritization.com/uploadedFiles/2011-09-21_Zandi_A-Clarification-of-Risk.pdf.

securitization, which would likely prevent originators from offering borrowers rate locks for the period between application and funding. Finally, the harsh impacts of the premium capture rules will be most severe for low and moderate income borrowers with less than prime credit histories, because securitizations of loans to such borrowers create significant amounts of excess spread. This will result in credit being less available to, and more expensive for, low to moderate income mortgage borrowers.

Most disturbing, however, is that the premium capture rule as currently proposed eliminates virtually all incentives to securitize for institutions other than those that securitize purely for financing. Institutions with other sources of funding will move away from securitization altogether, resulting in a constriction of credit and an increased cost of capital.

c. Proposed QRM Will Constrict Credit and Increase Cost

The highly conservative nature of the qualified residential mortgage ("QRM") definition will likely limit the availability, and increase the cost, of mortgage credit to consumers, particularly to those with low to moderate incomes. The risk retention proposing release indicates that approximately 19.79% of all loans purchased or securitized by the GSEs during the period 1997-2009, and approximately 30.52% of loans in 2009 alone, would have met the QRM criteria. In the current market, even highly creditworthy borrowers are continuing to experience difficulties in obtaining mortgage financing, as uncertainty in the world financial markets in general and the mortgage market in particular make obtaining credit difficult. This problem will be substantially exacerbated, and the availability of mortgage credit to consumers will suffer, if the QRM definition is not either expanded to include a greater percentage of the mortgage market or, as we have stressed in our comprehensive comment letter, modified to allow QRM loans and non-QRM loans to be included in the same securitization pools.

The QRM exemption to the risk retention requirements is only available if all the loans underlying the securitization are QRMs. This requirement effectively splits the securitization market into transactions backed by QRMs and transactions backed by non-QRMs. We are concerned that it may not be possible for sponsors to originate QRMs in numbers sufficient to generate the critical mass of loans necessary for economically efficient securitizations, which would invariably increase the cost of such loans. In order to alleviate this risk, we support establishing a "QRM blend" exception that would allow QRMs to be included in a pool that also contains non-QRMs, in a way that preserves the 0% risk retention requirement on the QRM portion of the pool and the 5% risk retention requirement on the non-QRM portion of the pool. The 5% risk retention requirement on the entire securitization would then be ratably reduced by the proportion of the total pool that meets the QRM standards. This would meet all the goals of the risk retention rules, while at the same time maintaining the feasibility of securitizing QRMs and avoiding the increased costs to borrowers that would follow if such securitizations were not economically efficient. We believe that this exception would be consistent with the statutory framework of Dodd-Frank.

d. Servicing Standards

The inclusion of servicing standards in the QRM definition goes well beyond the legislative intent of Dodd-Frank and its mandate for including criteria relating to underwriting and product features. There is no evidence, either in the legislative history or the language of

Dodd-Frank, that Congress intended to include servicing standards as part of risk retention rules. In fact, incorporating servicing standards into the QRM definition would have the peculiar result of regulating the servicing of the highest quality borrowers, those with the least risk of encountering servicing issues or needing loss mitigation, while the bulk of the market, consisting of borrowers with a greater need for loss mitigation, would be left unregulated. We believe that this effort should not be rolled out on a piecemeal basis, and instead support the separate interagency effort currently underway to develop national servicing standards that will benefit all borrowers of residential mortgage loans.

e. Reliance on GSEs Will Increase

Since the time the GSEs were placed into conservatorship, their economic significance has only increased, and they, along with the Federal Housing Administration ("FHA"), guarantee 90+% of American mortgages, as the private label MBS market continues to lie dormant. The proposed risk retention rules would impose significant burdens on issuers of private label MBS but provide that the implicit 100% taxpayer guarantee is a suitable form of "skin in the game" for the GSEs, effectively exempting them from the proposed risk retention rules. Securities guaranteed by the GSEs will be able to be securitized free from the risk retention requirements (including the premium capture rule and the resulting accounting issues) irrespective of whether such securities are QRMs, which will result in the non-QRM loans backing such securities having lower costs to borrowers and more attractive terms than similar loans offered by private market participants. This will have the effect of increasing the portion of the residential mortgage market dominated by the GSEs, further entrenching the importance of their role in such market. This will make it substantially more difficult for Congress to carry out its efforts to restructure or wind down the GSEs, since a substantial percentage of consumers will be wholly dependent on the GSEs to provide them with affordable mortgage financing.

ii. Reps and Enforcement Mechanisms Should Be Priority for RMBS

Without exception, our investor, originator and issuer members view appropriate representations and warranties and effective enforcement provisions as significant risk retention for RMBS transactions. In fact, ASF believes that risk retained through representations and warranties results in an even greater amount of skin in the game than the 5% risk retention mandated by Dodd-Frank because a repurchase is for 100% of the loan's unpaid principal balance. Furthermore, the principal goal of any risk retention initiative should be to establish and reinforce commercial incentives for originators to create and fund mortgage loans that conform to stated underwriting standards and other securitization eligibility criteria, thereby making those parties economically responsible for the stated attributes and underwriting quality of securitized loans. Our RMBS issuer and investor members strongly agree that the ASF Repurchase Principles effectively achieve that goal, and in a more direct manner than the proposed risk retention rules.

Appropriate "skin in the game" for securitization transactions begins with representations and warranties, which are used to allocate the origination risk of mortgage loans between the issuers of the securities and the investors who purchase them. Generally, if a loan is found to have breached the representations and warranties and such breach is sufficiently material, the loan can be "put back" or returned to the seller who is obligated to repurchase it, essentially effecting a 100% risk retention. Much like a defective product would be returned to the store from which it was sold, a materially defective mortgage loan would be returned to the issuer or other representing party through its removal from a securitization trust for the applicable repurchase price (or a qualified substitute loan, if applicable).

Historically, the type and form of representations and warranties included in RMBS transactions varied greatly, and investors often expressed concerns about their inability to compare the representations and warranties provided by different issuers. The ASF Model Reps were developed primarily to express customary market representations and warranties in the same, transparent language across transactions and provide a "baseline" against which investors and rating agencies can measure the representations and warranties contained in a particular transaction. Securitization transactions vary based on many factors, including the underlying collateral, the associated transaction parties, the types of bonds issued and the ultimate investors. Securitization investors have differing needs and risk tolerances and depending on the transaction, investors and/or issuers may be willing or unwilling to assume certain risks or certain representations and warranties simply may not be relevant. Because transactions can vary greatly, parties are free to determine which of the Model Reps are appropriate for a transaction and whether modifications to the language or form of the Model Reps should be made. The purpose of the Model Reps is to allow market participants to easily determine whether departures from the Model Reps have occurred and whether knowledge qualifiers were used, adding transparency to the negotiation process among the parties to a given transaction and enabling issuers and investors to more easily and better assess their willingness or unwillingness to assume origination risks.[26] The Model Reps also provide more significant protections by reworking the language of the representations and warranties contained in existing RMBS transactions and including many new provisions which did not previously exist.

Many investors believe that the repurchase process set forth in most existing securitization contracts does not provide applicable parties with an adequate means to pursue a repurchase demand nor does it effectively specify mechanisms to identify breaches or resolve a question as to whether a breach occurred. For these reasons, our membership began working towards the ASF Repurchase Principles to delineate a consensus framework for enforcing remedies with respect to representations and warranties in RMBS transactions by, among other things, establishing the role of a new "independent reviewer" that will have access to the files of applicable mortgage loans to determine if a breach has occurred and requiring a robust mechanism for the investigation and resolution of disputes regarding breaches of transaction representations and warranties. The basic elements of the framework involve (i) review of pool assets by an independent third party that is given access to the loan files for compliance with representations and warranties following the occurrence of an agreed-upon "review event," (ii) recommendation by the independent third party to the securitization trustee of whether or not to demand repurchase of, or substitution for, the pool asset by the representing party and (iii) if the

[26] We also note that Dodd-Frank and recent rules issued by the SEC require each nationally recognized statistical rating organization ("NRSRO") to include in any report accompanying a credit rating a description of (i) the representations, warranties, and enforcement mechanisms available to investors; and (ii) how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities.

representing party disputes the independent third-party's findings, submission of the dispute to a binding dispute resolution process.[27]

ASF believes that the strong third-party mechanism set forth in the ASF Repurchase Principles will ensure that representations and warranties in future RMBS transactions are subject to a clearly defined enforcement mechanism, with the beneficial effect of causing asset originators to exercise caution in underwriting and deterring transfers of substandard assets to securitization vehicles. ASF has recommended that all future RMBS transactions of newly-originated mortgage loans include a repurchase framework that is consistent with the ASF Repurchase Principles. Finally, our members would have concerns with any regulator-produced model that strayed from these core principles, which market participants spent over six months discussing and refining.

C. Legal Certainty

i. Subordinate Liens

Another goal of Chairman Garrett's legislation is to remove so-called "conflicts of interest" between servicers and investors where servicers service the first lien, and hold the second lien on portfolio. Often the contract for the second lien is consummated sometime after the first lien, and the first lien holder is unaware both of the existence of the second lien as well as the holder of the second lien. This is why the second lien is often referred to as a "silent second." Although our investor and originator/servicer members remain split as to the ultimate

[27] We believe that the ASF Repurchase Principles would be generally consistent with the re-proposed conditions for shelf eligibility for ABS proposed by the SEC on July 27, 2011 if the SEC were to incorporate the comments we submitted on October 4, 2011. See the SEC's proposal at http://www.sec.gov/rules/proposed/2011/33-9244fr.pdf and our comments at http://www.americansecuritization.com/uploadedFiles/ASF_Comment_Letter_on_SEC_Reg_AB_II_Re-Proposal_10-4-11.pdf.

impact of this issue with respect to the crisis, it is clear the second lien transaction remains a blind spot to first lien investors.

ii. Mandatory Principal Write-Downs

ASF strongly supports the measure in Chairman Garrett's legislation that would prevent regulators from unilaterally forcing investors to reduce the principal balance of loans in which they have invested. ASF believes that borrowers, investors, and issuers should be allowed to work together to modify mortgages as they deem appropriate. While some ASF members have chosen to engage in limited principal reduction initiatives to maximize net present value on highly select loans, we believe that, lacking an explicit directive from Congress, any federal regulatory initiative to force investors to take losses as part of a mandatory principal reduction scheme is poor public policy and ultimately violative of basic contract law.

Industry participants have deployed and will continue to deploy aggressive efforts to prevent as many avoidable loan defaults and foreclosures as possible. No securitization participant—including lenders, servicers, and investors—benefits from these foreclosures. However, across-the-board mandatory principal reduction is not the solution to this challenge. In modifying troubled mortgages, reducing a borrower's principal balance creates perverse incentives for homeowners to strategically default on their mortgages in order to lower their overall cost. Investors and taxpayers, who are effectively Fannie Mae and Freddie Mac investors over the course of their federal conservatorship, stand to lose enormously, as the value of their secured assets would necessarily be trimmed. Indeed, Fannie and Freddie, propped up by the taxpayers, would be the hardest hit firms, as they currently command the vast majority of the mortgage market. We note that the FHFA, as Fannie and Freddie's conservator, has consistently resisted calls for principal reduction in an effort to protect taxpayers from these losses.

The idea of a principal reduction scheme has most recently been suggested as an element of the settlement talks currently being conducted among bank servicers and several federal agencies and state attorneys general.[28] Our institutional investor members are strongly opposed to any settlement for alleged servicing violations that investors had no control over that requires loans owned by investors to be modified or written down, particularly if write downs on subordinate liens weren't mandated in greater proportions. We believe that the circumstances of individual borrowers require modification options that are best worked out among borrowers, servicers, and investors, not through government mandate, in whatever form it may come. Put simply, housing policy cannot be solved with one-size-fits-all regulatory decrees.

Moreover, mandating principal write-downs as a sanction for any servicing improprieties, but against the interests of the investors that provide capital for new loans, would serve only to reinforce investors' uncertainty with respect to the legal rights and obligations under securitization contracts. Uncertainty around these rights and the rule of law in the broader securitization market remains one of the greatest obstacles to bringing new money back into the marketplace. For investors and the private market to return and replace taxpayers and Fannie and Freddie, the rule of law around securitization contracts must be honored and enforced. Until investors' fears over these issues are put to rest definitively, the recovery of the housing market, and with it the broader economy, will remain stalled.

[28] See Morgenson, G. (October 29, 2011). A Deal That Wouldn't Sting. *The New York Times*, available at http://www.nytimes.com/2011/10/30/business/a-foreclosure-settlement-that-wouldnt-sting.html.

For the above reasons, ASF fully supports Chairman Garrett's measure to restrict regulators from forcing principal reductions on loans owned by investors.

iii. Third Party Trustee

ASF supports efforts to ensure that trustees for mortgage-backed securities transactions are independent from the sponsors of such transactions. Section 101(g) of Chairman Garrett's bill provides that at all times there be one or more trustees for pools of mortgages that act as collateral for qualified securities, and that the Director issue rules requiring that such trustees be qualified and be independent using the same requirements as set forth in the Trust Indenture Act of 1939 (the "Trust Indenture Act"). ASF notes that these provisions are consistent with practice today on all private label RMBS transactions, both for publicly offered securities that are not governed by the Trust Indenture Act (transactions in which the securities are issued pursuant to a pooling and servicing agreement or a trust agreement) as well as transactions that are not publicly offered. This is the case in part because of legal constraints (such as the requirements of the Investment Company Act of 1940 or ERISA), as well as because of investors requiring that there be an independent trustee. Thus, even when the legal constraints mentioned above do not apply, RMBS transactions do not occur without an independent trustee.

Regarding the reporting of claims requirement of the bill, ASF believes that such a requirement does not pose a large burden on the trustees, but there would need to be more clarity as to what constitutes a claim against a sponsor. ASF notes that Section 943 of the Dodd-Frank Act already provides that securitizers are required to report when a noteholder requests that a loan be repurchased because of a breach of a representation or warranty with respect to such loan. That information is required to be reported regardless of whether the transaction is privately or publicly held. Also, such claims are typically not made against the sponsor, but against some intermediate entity that is owned by the sponsor.

The bill also contains provisions attempting to protect investor rights, and which require each trustee to maintain a list of investors and to be a means for investors to communicate with each other. These provisions in their current form will have some significant implementation difficulties to improve investor communications because the trustees do not have access to that information. In most RMBS transactions, the Depository Trust Company ("DTC") is the registered owner of the securities. DTC holds the securities as the nominee of financial institutions ("DTC Participants"), which hold the securities for themselves, for their customers (the ultimate "Beneficial Holders") or for other financial institutions which in turn hold the securities for themselves or their customers. Sometimes Beneficial Holders do not hold the securities in their own name, but instead hire a custodian bank to hold the securities on their behalf. The only information a trustee can get from DTC is the name of the DTC Participants. The only way that the trustees can obtain the information that appears to be required by Subsection (g)(5) would be to have an additional requirement that every Beneficial Holder inform the applicable trustee of the securities it holds. Another way to address this may be to require Beneficial Holders to inform DTC of their identities and allow investors and/or trustees to access the lists through DTC. DTC does charge a fee to the trustees each time they request a participant list, so updated inquiries will certainly increase the costs of the transaction. Although this may not be a large amount for each transaction, depending on how often a trustee would need to update the list through DTC, but the amount would be quite large over all RMBS transactions. Another challenge with the provision is that it is not clear what it means to facilitate communications among investors, or how this could be done while complying with the requirement that the trustee not make the list of investors available to other investors. As a prophylactic measure, protections should be put in place to ensure that the trustees are not responsible for the content of the communications by investors.

Regarding the independent third party, the provisions in the bill will help codify practice on some transactions and raise many additional questions. Current practice is that if investors want to review files of collateral in an MBS transaction, they contact the trustee and arrange, at their own expense, to have the files reviewed by an accounting or other type of firm that has expertise in reviewing collateral files. The holders then report the findings of the review to the trustee and/or the sponsor or servicer of the transaction, which leads to a negotiation with the sponsor or another entity responsible for the representations and warranties in the transaction. This process is not always smooth, as historical agreements have not typically provided details about how this should be dealt with by the parties. The language in the bill would help clarify for trustees (and/or the related custodians of the mortgage files) that they have an obligation to provide access to the files. However, one key challenge for the market to address is who is required to pay for the review or whether the trustee is expected to monitor the process or make any decisions with respect to the scope of the review or monitoring of the third party to ensure that it followed the procedures established for the review.

iv. QM Safe Harbor

The qualified mortgage rule was originally proposed by the FRB, but responsibility for the final rule was transferred to the CFPB on July 21, 2011. The proposed rule establishes the "qualified mortgage" as a standard for complying with Dodd-Frank's requirement that lenders make a reasonable determination that a consumer has the ability to repay a mortgage loan. The proposal contemplates and requests comment on two levels of protection for meeting the standard, one resulting in a "safe harbor" from liability and the other resulting in a presumption of compliance that could later be rebutted.

As a threshold issue, ASF believes it is essential that the final rule minimize the legal risk to investors in residential mortgage loans. Liquidity in the residential mortgage market relies on investors that reasonably believe that loans are enforceable in accordance with their terms, without unnecessary impairment due to assignee liability or an inability to realize on the collateral. To achieve this critical goal, the proposed rule must be revised in two ways.[29]

First, the QM definition includes subjective and vague factors that will make it difficult or even impossible to determine, at the time a loan is made, whether or not the loan qualifies as a QM. For instance, Dodd-Frank specifies that a QM is a residential mortgage loan "for which the income and financial resources relied upon to qualify the obligors on the loan are verified and documented." An originator may indeed exert a reasonable, good faith effort to verify and document a consumer's income and financial resources in underwriting a loan, but without any clear-cut standards for accomplishing that task, the originator and the investors in the loan may

[29] To see all of our comments on the QM rule proposal, please see http://www.americansecuritization.com/uploadedFiles/ASF_Comments_on_Ability_to_Repay_QM_Proposed_Rule_7_22_11.pdf.

be subject to second-guessing. Second, ASF strongly recommends that the CFPB provide an actual safe harbor that provides the legal certainty for originators and loan investors that Dodd-Frank intended. An after-the-fact finding of non-compliance with the QM rule would result in substantial liability for investors and other assignees down the capital markets chain. Reasonable access to credit will depend upon the outcome of the QM, as liability concerns may prevent lenders from originating mortgage loans that fall outside the standard.

D. Transparency and Disclosure

i. Loan-Level Disclosure

ASF has become the market leader in promoting transparency for private label RMBS securitizations. On July 15, 2009, ASF released final versions of the first two deliverables of Project RESTART, a disclosure package of loan-level information to be provided by issuers prior to the sale of private-label RMBS transactions (the "Disclosure Package") and a reporting package of loan-level information to be updated on a monthly basis by RMBS servicers throughout the life of an RMBS transaction (the "Reporting Package"). Both of these packages increase and standardize critical data at issuance and throughout the life of a transaction, which will enable investors to better perform deal and loan-level analysis on the basis of the credit quality of the underlying mortgage loans. By increasing data and standardizing available information, institutional investors will be able to better distinguish pools of high quality loans from lesser quality pools.

The release of the Disclosure and Reporting Packages was timely given the Administration's proposals for regulating financial markets in the summer of 2009 and the introduction of financial regulatory reform legislation later that year. The Dodd-Frank Act specifically calls for issuers of ABS to disclose "asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence." Not long before the passage of the Dodd-Frank Act, the SEC proposed Reg AB II, which includes loan-level RMBS disclosure and reporting proposals as originally contemplated and designed by Project RESTART. ASF has commented extensively both on Reg AB II and on the SEC's re-proposals of certain of the provisions of Reg AB II issued this summer, and we generally concur with both the substance and format of the SEC's proposed rules regarding disclosure of asset-level information for RMBS transactions, although we have also proposed some specific modifications.[30]

ii. ASF LINC

In connection with the development of the Disclosure and Reporting Packages, ASF also created a unique loan identification number, known as the ASF LINC™, for securitization reporting purposes to facilitate the monitoring of assets from origination through the securitization process.[31] ASF's LINC™ would serve as an effective model for the alphanumeric identification code for loans called for in Chairman Garrett's bill. One of the problems in the securitization market has been the inconsistent fashion in which assets have been identified. In a typical mortgage securitization, the originator, primary servicer, master servicer and trustee could all assign different numbers to identify the loan on each particular system. Implementation of the ASF LINC™ remedies this problem by assigning numbers that will be standard across the

---

[30] For ASF's 172 page Reg AB II Broad Comment Letter, see http://www.americansecuritization.com/uploadedFiles/ASFRegABIICommentLetter8.2.10.pdf. For ASF's comment letter regarding the Reg AB II re-proposals, see http://www.americansecuritization.com/uploadedFiles/ASF_Comment_Letter_on_SEC_Reg_AB_II_Re-Proposal_10-4-11.pdf.
[31] To view a sample of the code and a graphical depiction of its structure, see http://www.americansecuritization.com/uploadedFiles/ASF_LINC.pdf.

entire industry, enabling market participants to track an asset throughout its life regardless of who holds legal title to or services it at any particular time. ASF also released an RMBS Bond-Level Reporting Package consisting of data fields that provide enhanced and standardized reporting of bond-level information throughout the life of an RMBS transaction.

iii. Cooling-Off Period

Chairman Garrett's bill includes a provision requiring that preliminary prospectuses containing all material terms be filed five days before investors make an investment decision in ABS. This proposal is similar to a Reg AB II proposal by the SEC to require an asset-backed issuer using a shelf registration statement to file a preliminary prospectus containing substantially all required information at least five business days in advance of the first sale of securities. We appreciate Chairman Garrett's and the SEC's goal of providing investors with adequate information and time to make an investment decision. However, our issuer and investor members uniformly agree that a mandatory waiting period of five calendar or business days is appreciably too long, providing investors with considerably more time than is necessary to analyze most ABS transactions and exposing issuers and investors to market risk for a minimum, in the case of the SEC's proposal, of an entire week (five business days effectively equates to seven calendar days), and longer in the case of waiting periods that include holidays.

Most ABS are done as "shelf" transactions that are part of a program of issuances by a securitizer that is well known to the marketplace, and are conducted by means of a prospectus prepared at the time of the issuance that supplements the information included in the prospectus filed as part of a shelf registration statement. For example, in the case of revolving asset master trusts (such as credit cards), the prospectus filed as part of the registration statement typically includes detailed information concerning the legal structure of the program and transactions, the securitizer's credit-granting or underwriting criteria and the composition and performance of the pooled assets, including historical and static pool information. In the case of amortizing asset pools (such as auto loans), while information regarding the transaction structure and specific assets comprising the asset pool is not known until the time of the issuance, the marketplace is typically familiar with the securitizer's credit-granting or underwriting criteria as well as historical and static pool information relating to the securitizer's managed portfolio and prior securitized pools.

Thus, while it is the case that, for the most part, each ABS offering involves securities backed by different assets (obvious exceptions being revolving asset master trusts such as credit card master trusts), our issuer and investor members agree that a five calendar or business day waiting period is too long. Our investor members indicate that they have the staff and expertise to evaluate most ABS shelf transactions within two business days. In the more limited cases where a transaction or structure is unfamiliar or more complex, investors indicate that they can and do insist on more time before they make an investment decision. Conversely, in cases where a transaction or structure is very familiar, our investors agree that they need considerably less time before they make an investment decision.

Moreover, our issuer and investor members agree that a mandatory minimum waiting period that is too long unnecessarily interferes with market mechanics, to the detriment of issuers and investors, by artificially delaying pricing and the formation of contracts of sale and exposing issuers and investors to the vagaries of market movements that may be adverse to one or the other. For all of these reasons, our issuer and investor members agree that a two business-day waiting period would strike a more appropriate balance between the needs of investors and the interests of issuers than a five business day waiting period, and we have communicated this fact to the SEC in our broad Reg AB II comment letter.[32] However, we do not believe it is appropriate to include any particular time period in the proposed bill, as Congress may not be nimble enough to modify the time period should evidence arise that such period is too long or too short. Instead, we suggest leaving the exact length of the waiting period to the SEC, which is in a better position than Congress, based on extensive market commentary, to monitor and react to changes in the ABS market.

iv. TRACE Dissemination

ASF is also supportive of efforts to increase the transparency of structured finance products and markets, particularly through expanding the scope of Trade Reporting and Compliance Engine ("TRACE") reporting requirements. Therefore, ASF views favorably Chairman Garrett's goal of disseminating transaction, volume, and pricing information of trades in ABS through TRACE, as outlined in Section 203 of his legislation. ASF has in the past provided detailed comment and recommendations for the implementation of a more comprehensive reporting regime for transactions using TRACE.[33] We believe that improvements to the regulatory reporting of trades of securitized products to the Financial

[32] The SEC's proposal would also have called for a five business day waiting period in the case of a material change in the information provided in the preliminary prospectus. In response to that proposal, our issuer and investor members agreed that, if a mandatory minimum waiting period is to be imposed at all, a one business-day waiting period is more appropriate. However, issuers and investors also agree that even a one business day waiting period is too rigid and may be unnecessarily long in many cases.

[33] For ASF's November 18, 2009 comment letter to the SEC regarding TRACE reporting, see http://www.americansecuritization.com/uploadedFiles/ASF_SIFMA_ResponseFinraTRACE_ABS_SR-FINRA-2009-065_2009-11-18.pdf.

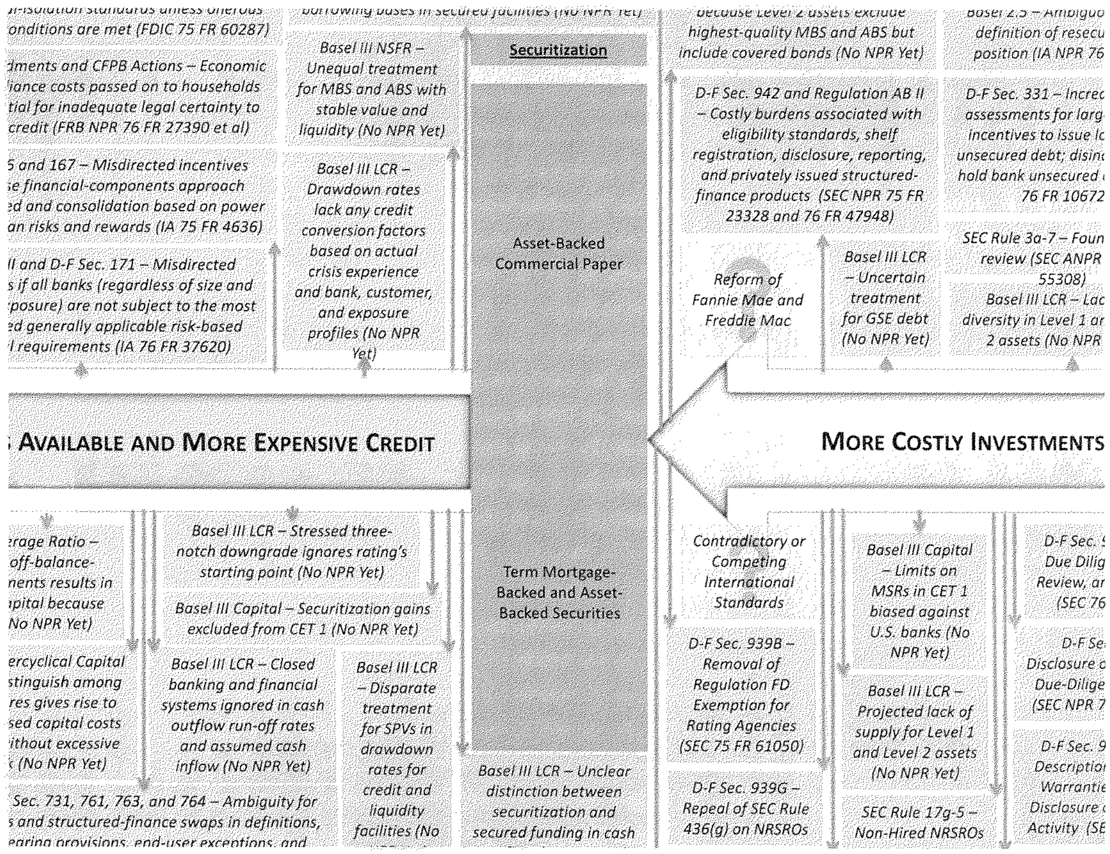
Industry Regulatory Authority ("FINRA") through TRACE can provide an opportunity for greater clarity with regard to the securitization market, a necessary component of the reestablishment of normal levels of credit availability.

V. Conclusion

The ASF has been a strong and vocal advocate for targeted securitization market reforms and we seek to continue to work constructively with policymakers to identify and implement them. We applaud the willingness of the Chairman to convene this hearing to continue to push forward the discussion of the future of the U.S. mortgage finance system. We greatly appreciate the invitation to appear before this Subcommittee to share our views. I look forward to answering any questions the Subcommittee may have.

Thank you.

ATTACHMENT A


onditions are met (FDIC 75 FR 60287)
iments and CFPB Actions – Economic
iance costs passed on to households
tial for inadequate legal certainty to
credit (FRB NPR 76 FR 27390 et al)
5 and 167 – Misdirected incentives
se financial-components approach
ed and consolidation based on power
an risks and rewards (IA 75 FR 4636)
II and D-F Sec. 171 – Misdirected
s if all banks (regardless of size and
posure) are not subject to the most
ed generally applicable risk-based
l requirements (IA 76 FR 37620)
Basel III NSFR – Unequal treatment for MBS and ABS with stable value and liquidity (No NPR Yet)
Basel III LCR – Drawdown rates lack any credit conversion factors based on actual crisis experience and bank, customer, and exposure profiles (No NPR Yet)
Securitization
Asset-Backed Commercial Paper
Term Mortgage-Backed and Asset-Backed Securities
highest-quality MBS and ABS but include covered bonds (No NPR Yet)
D-F Sec. 942 and Regulation AB II – Costly burdens associated with eligibility standards, shelf registration, disclosure, reporting, and privately issued structured-finance products (SEC NPR 75 FR 23328 and 76 FR 47948)
Reform of Fannie Mae and Freddie Mac
Basel III LCR – Uncertain treatment for GSE debt (No NPR Yet)
definition of resecu
position (IA NPR 76
D-F Sec. 331 – Increa
assessments for larg
incentives to issue lo
unsecured debt; disinc
hold bank unsecured
76 FR 10672
SEC Rule 3a-7 – Foun
review (SEC ANPR
55308)
Basel III LCR – Lac
diversity in Level 1 ar
2 assets (No NPR
AVAILABLE AND MORE EXPENSIVE CREDIT
MORE COSTLY INVESTMENTS
rage Ratio –
off-balance-
nents results in
pital because
No NPR Yet)
ercyclical Capital
stinguish among
res gives rise to
sed capital costs
ithout excessive
(No NPR Yet)
Basel III LCR – Stressed three-notch downgrade ignores rating's starting point (No NPR Yet)
Basel III Capital – Securitization gains excluded from CET 1 (No NPR Yet)
Basel III LCR – Closed banking and financial systems ignored in cash outflow run-off rates and assumed cash inflow (No NPR Yet)
Basel III LCR – Disparate treatment for SPVs in drawdown rates for credit and liquidity facilities (No
Sec. 731, 761, 763, and 764 – Ambiguity for
s and structured-finance swaps in definitions,
Basel III LCR – Unclear distinction between securitization and secured funding in cash
Contradictory or Competing International Standards
D-F Sec. 939B – Removal of Regulation FD Exemption for Rating Agencies (SEC 75 FR 61050)
D-F Sec. 939G – Repeal of SEC Rule 436(g) on NRSROs
Basel III Capital – Limits on MSRs in CET 1 biased against U.S. banks (No NPR Yet)
Basel III LCR – Projected lack of supply for Level 1 and Level 2 assets (No NPR Yet)
SEC Rule 17g-5 – Non-Hired NRSROs
D-F Sec.
Due Dilig
Review, ar
(SEC 76
D-F Se
Disclosure o
Due-Dilige
(SEC NPR 7
D-F Sec. 9
Descriptio
Warrantie
Disclosure
Activity (SE

Testimony of

Martin S. Hughes

President and Chief Executive Officer

Redwood Trust, Inc.

Before the

United States House of Representatives

Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing on

The Private Mortgage Market Investment Act

November 3, 2011

Washington, D.C.

REDWOOD TRUST

Redwood Trust, Inc.

One Belvedere Place, Suite 300

Mill Valley, CA 94941

415-389-7373

www.redwoodtrust.com

INTRODUCTION

Good Morning Chairman Garrett, Ranking Member Waters, and Members of the Subcommittee. My name is Marty Hughes, and I am the CEO of Redwood Trust, Inc., a publicly traded company listed on the New York Stock Exchange that invests in mortgage credit risk. I appreciate the opportunity to testify on the draft legislation entitled "The Private Mortgage Market Investment Act."

OVERVIEW

Mr. Chairman, I first want to commend you for introducing this legislation. You have obviously put a great deal of time and effort into understanding the structural problems of the secondary mortgage market, and have now drafted comprehensive legislation to address those problems. While the fact finding part of the legislative process will continue, it is very encouraging to see the drafting process get underway.

There are two equally important impediments to the redevelopment of a robust private MBS market. The first is structural deficiencies in the mortgage securitization process that impede investor confidence, and the second is extensive government subsidies that crowd out the private sector.

Before I move to the main part of my testimony, let me say something briefly about the overreach of government subsidies. While they may have been necessary at the peak of the market crisis, the subsidies can now be scaled back without dire consequences. This was proven when the GSE and FHA conforming loan limits were reduced on October 1. There was a smooth transition in the market to the new lower limits. All the warnings of borrowers getting shut out of the market or getting charged 300 basis points higher interest for a loan, have proven to be wrong. Borrowers above the new conforming loan limit are getting loans and the current spread over a conforming GSE mortgage has averaged less than half a percent.

I understand that the Senate has recently adopted an amendment to an appropriations bill that would extend the higher loan limits yet again, even after they have already been reduced without dire consequence. I urge the Committee to reject that amendment.

The legislation you have introduced, addresses many of the structural deficiencies in the housing finance process that caused problems and that continue at this time to deter investor confidence. This is very important. Without investor confidence and willingness to take on mortgage credit risk, there will not be a broad resurgence in the private MBS market. Investors in a Ginnie Mae or a GSE mortgage security are not buying mortgage credit risk; they are buying US government credit risk.

Redwood has managed to now issue three fully private MBS transactions through sound underwriting controls and structural enhancements that have gained the confidence of investors. However, the private market we have revived will remain very small without the kind of broader structural reforms contained in the legislation.

THE PRIVATE MORTGAGE MARKET INVESTMENT ACT OF 2011

I would now like to comment on a few of the specific provisions of the legislation and also to propose consideration of some additional provisions.

Standard Mortgage Classifications

The legislation directs the FHFA to establish classifications for mortgages securities having different degrees of credit risk, ranging from little to substantial. The FHFA will also establish criteria for each classification, and develop standard form securitization agreements. The legislation would not prohibit nonstandard mortgage products – they would just be subject to a different regulatory regime. This construct is generally workable and the effort to build more standardization into the mortgage process is the right objective.

Second Liens

The legislation addresses issues regarding second liens in three ways, by permitting a servicer of a first lien loan to charge additional fees if a second results in a CLTV of 80% or more, by requiring notice to the servicer of the first if a second is put in place, and also in the context of servicer conflicts. While these proposed provisions go a long way toward addressing the second lien issue, we propose that consideration be given to addressing this issue more broadly as well.

A lender who makes a first lien residential mortgage loan considers the credit quality of the borrower, the value of the property that serves as collateral, and the relationship between the size of the loan and the property value, the LTV ratio.

The credit quality analysis includes a determination of whether the borrower will be willing to make the required mortgage payments, a determination that takes into account the borrower's equity in the property. The more equity that the borrower has in the property, the less likely that the borrower will default on the mortgage payment obligation.

In the event that a lender makes an 80% LTV loan, and the borrower subsequently takes out a second, the credit quality of the first will have deteriorated. The LTV will have increased and the borrower's equity in the property will have decreased. In addition, the borrower's debt burden will have increased. All in all, the borrower will have less incentive to avoid default and will be more likely to default.

Investors in RMBS backed by newly originated firsts will have the same experience as the lender. When investors invest in RMBS backed by a pool of 80% firsts, they do not want to find that defaults exceed expectations because subsequently originated seconds have resulted in CLTVs of 90% or more.

In many forms of secured lending, it is common for a borrower to be required to get the consent of first lien holders in order to be permitted to incur additional debt. This feature could be imported into residential mortgage finance by contractually requiring that a borrower obtain the consent of the first lien holder (which is the RMBS trustee where the loan has been securitized) before taking on a second if the CLTV would exceed a specified threshold.

If the borrower nevertheless took on the second without the consent of the first lien holder, the first lien holder should be permitted to declare the loan immediately due and payable (often referred to as a "due-on-sale clause"). This solution would require Congressional consent to amend the Garn-St. Germain Depository Institutions Act of 1982 which currently prohibits the exercise of due-on-sale clauses triggered by the creation of a subordinate lien.

Identification of Representation and Warranty Breaches

The proposed legislation addresses the issue of rep and warranty breaches by contemplating a process for mandatory arbitration in the event of a disagreement between investors and issuers on whether there was a breach obligating an originator or securitization sponsor to repurchase a loan or to indemnify a loss

The proposed legislation also contemplates appointment of an independent third party by a majority of the investors to, among other things, inform the trustee of any securitization agreement breaches. We agree that the designation of someone to identify breaches is essential in order for the mandatory arbitration provision to have its intended impact.

Redwood has in our three recent securitizations pioneered the use of mandatory arbitration to resolve disputes on securitization rep and warranty put back claims and we have also designated a party in our securitizations to identify breaches and to make claims. Namely, the party who owns the first loss pieces (that is the party who will bear the loss first if the claim is denied) has the right to determine what actions to pursue. And, if the AAA investors disagree with a decision not to pursue a claim, those investors can, through a vote, compel the master servicer or trustee to pursue the claim. We believe that the interests of all parties to a securitization are best served if the party with the greatest incentive to investigate claims is the party designated to do so rather than an independent third party. On the one hand, an independent third party would have no skin in the game and therefore no incentive to aggressively identify and pursue claims. On the other hand, in order to avoid second guessing, an independent third party might make claims excessively, in respect of every delinquency, resulting in excessive costs to the trust.

We recognize the importance of this issue and we would be happy to discuss the details of our structure and our concerns with you in more detail.

Investor Enforcement Mechanism

Many of the most important actions that can be taken in a securitization require the consent or direction of all or a specified portion of the transaction's investors. For example, many proposed amendments to the transaction documents require the approval of a majority of investors while other amendments require the approval of all investors. In addition, investors often have the power to remove transaction parties upon the occurrence of specified events, such as the failure to remit a payment within the specified period, the bankruptcy or insolvency of the party or the material failure to observe a covenant.

It is often the case that no single investor holds a large enough portion of the certificates to independently meet the threshold that is required to take particular actions. In these situations, multiple investors would be required to coordinate their efforts in order to direct or consent to a proposed action. However, many investors hold their interests indirectly in the form of beneficial interests in securities in which the holder of record is a clearing agency (such as The Depository Trust Company or its nominee). Neither the transaction parties nor the investors are able to efficiently discover the identity of any investor holding such a beneficial interest through a clearing agency. As a result, situations may arise where multiple investors want to take an action and would, taken together, meet the threshold but are unable to move forward due to an inability to communicate with each other.

In order to address this issue, a centralized clearing-house for bond registry or other mechanism should be created which would facilitate the ability of investors to communicate with each other.

Some private companies have attempted to create a limited bond registry by inviting investors to volunteer information about their holdings.[1] However, this approach is limited as holders may not be aware of these companies and the registry would only become useful if a large number of holders supply their information.

The SEC recently re-proposed certain rules, often referred to as "Regulation AB II", which contained, among other things, a proposal to facilitate investor communication. Under this proposal, periodic Form 10-D filings would be required to include any request from an investor to communicate with other investors for the purpose of exercising investor rights. As currently proposed, this rule would only apply to shelf-eligible transactions and not other registered transactions or private placements.

We propose that mechanics to facilitate investor communications would make securitizations more attractive to investors and we propose that the legislation be broadened to address this issue.

Servicer Conflicts and Servicer Performance

A servicer plays a significant role in the overall performance of a securitization. Investors generally expect a servicer to act in the best interests of the trust as a whole. However, circumstances may exist which may give rise to potential conflicts of interest which raise a question as to whether the servicer is acting in a manner contrary to the interests of the trust and investors.

In addition, although a servicer is engaged to service mortgage loans in a securitization pool for the benefit of the investors, the investors typically have a limited ability to directly influence the activities of the servicer. One reason for this is that there are few objective standards by which a servicer's performance may be measured.

Conflicts

The proposed legislation addresses servicer conflicts by prohibiting a servicer from servicing a first mortgage if it has an interest in a second lien secured by the same property. Other conflicts, or appearances of conflicts, that may merit focus is when a servicer or a servicer's affiliate owns classes of bonds in a securitization, which gives rise to the concern that servicer actions will favor one class over another .

---

[1] For example, Talcott Franklin, a Dallas-based attorney, created a clearing house by inviting investors to submit information under the attorney-client privilege about their holdings for inclusion in a database which would then be used to facilitate collective action with other investors in the same securitization. The clearing house website can be found at http://web.me.com/jennifertfranklin/Talcott_Franklin_P.C./Clearing_House.html.

Surveillance

Even when there are no conflicts, in order to assure investors that the servicer is fulfilling its responsibilities, standards should be developed to govern when a trustee must investigate the servicer's performance. For example, a trustee could be required to examine situations where there have been excessive loss severities, high levels of modification activity, early payment defaults, and excessive foreclosure delays.

In addition, standards could be developed for appointment of a third-party credit risk manager to conduct ongoing surveillance of servicing activities and to report its findings to the trustee and the investors on a regular basis.

Servicer Performance Triggers

To give investors a measure of control over the servicer, servicer performance triggers could be established based on industry best practices benchmarks. The triggers could relate to, among other things, average loss severity, adherence to foreclosure timelines, and average REO liquidation timelines. Hearings should be held with industry participants in order to help create these benchmarks and the benchmarks should be reviewed on a periodic basis.

Presumably, a securitization in which a servicer is under-performing would have many borrowers in various stages of delinquency and default. In these cases, it can be extremely detrimental to a borrower to transfer servicing in the middle of a loss mitigation process. Many of the problems we see today - misplaced documents, starting and stopping of foreclosure, and inconsistency of help would be exacerbated by transferring the borrower to a new servicer.

Instead of requiring the termination of the servicer, all servicers should have a plan in place with a specialty servicer for taking over the servicing of the loans. This plan should include compatible servicing systems, systematic note taking and consistent mailing addresses, emails and fax numbers for borrowers to use. If a servicer's performance is measurably below the benchmarks, this specialty servicer would step-in and take over the servicing at no additional cost to the trust.

Many traditional RMBS securitizations provided for the possibility of removal of the servicer upon the occurrence of an "event of default" such as a material failure by the servicer to observe a covenant. However, because many events of default were formulated with general language rather than by reference to specific and clear triggers, the question of whether an event of default occurred could be subject to dispute. Also, removal of the servicer following an event of default often required the direction by a threshold level of investors, thereby introducing issues regarding impediments to investor coordination. By using clear triggers and an efficient mechanism to avoid disruption to a borrower and to put a specialty servicer in place once a trigger is hit (at no additional cost to the trust), investors would have greater comfort in the servicer's ability to minimize losses.

CONCLUSION

I encourage you to move aggressively with enactment of this very important legislation during this Congress and not let it get sidetracked with more complicated issues, such as GSE reform. This legislation, along with regulatory plans to "level the playing field", could spur a broad resurgence of the private MBS market in the short-term, for the benefit of homeowners, lenders, and investors. In fact, I expect you will find that the velocity gained in the private MBS market as a result of this legislation will likely broaden your policy options for a final long-term resolution of the GSEs, and what, if anything, replaces them.

Thank you for inviting me to testify and I look forward to answering any questions.

Center for American Progress Action Fund

Statement of Janneke Ratcliffe
Senior Fellow
Center for American Progress Action Fund
Executive Director
Center for Community Capital
University of North Carolina at Chapel Hill

before

The Subcommittee on Capital Markets and Government-Sponsored Enterprises
United States House of Representatives

hearing on

"The Private Mortgage Market Investment Act"

November 3, 2011

Good morning Chairman Garrett, Ranking Member Waters, and members of the subcommittee. I am Janneke Ratcliffe, a Senior Research Fellow at the Center for American Progress Action Fund and the executive director for the Center for Community Capital at the University of North Carolina at Chapel Hill.

Thank you for the opportunity to testify today about the draft Private Mortgage Market Investment Act, which addresses a number of the important challenges that must be overcome to restore a well-functioning system of housing finance in America. I am honored to speak as a member of the Mortgage Finance Working Group, a group of mortgage finance experts convened by CAP who have authored a plan for responsible mortgage finance reform. Though I will summarize many aspects of that proposal in this testimony, I speak only for myself in any views expressed here today. I also offer my thanks to CAP's John Griffith for his assistance in preparing this testimony.

I will speak today about the discussion draft and how the regulatory framework it offers might fit in the broader mortgage finance system. The Mortgage Finance Working Group proposal, like most others, aims to have private capital at-risk play a much greater role in the market than it is playing today. In order for that to happen, investor confidence in non-guaranteed securities must be restored, and the bill lays out several steps that will be helpful to that objective.

Most importantly, this bill recognizes that the federal government is critical to a well-functioning mortgage market—even a purely private one—for both writing the rulebook and refereeing when the game begins. If implemented a decade ago, many of these thoughtful oversight measures likely would have staved off the bubble and bust of the mid 2000s and resulting financial crisis. I'm pleased to see the regulation of private mortgage-backed securities finally garnering the congressional attention it deserves.

While I applaud many of the solutions identified in this bill, other provisions raise questions that merit further analysis and modification. I'll also identify some significant concerns and limitations of the draft bill.

Specifically, I will discuss the following:

- Congress should focus on incremental steps for bringing back private investor confidence so the government sponsored enterprises, or GSEs, can stop serving borrowers and market segments that don't need them. But some government role in ensuring liquidity and access remains critical for the majority of the $11 trillion mortgage market. It would be unwise to pull the rug out from under the market by scaling back this support too quickly.

- Standardization of products, terms, and conditions is absolutely critical, but there are serious dangers to relying too heavily on borrower-based risk assessments and ignoring other loan features and delivery channels that are proven risk indicators. Borrower-related risk criteria are not always reliable determinants of default, and the last thing we want is to repeat the mistake of consigning borrowers with fewer resources to higher risk, higher-cost products.

- Consumer protections, transparency requirements, and loan-level disclosures are welcomed changes to the private-label securities, or PLS, market. But they could potentially have a negative impact on the "to be announced," or TBA market, making this regime a useful complement but not a viable substitute for the conforming loan market.

- Certain provisions of the draft bill are problematic and ought to be reconsidered, including the proposals to strike the risk retention requirements, ban principal reduction initiatives across the government, and change qualifying mortgage rules.

- Some fundamental questions need to be addressed, including issues surrounding choosing the best regulator to fulfill the mandate and how this bill fits in with other GSE reform proposals currently before this subcommittee.

- Other critical next steps toward a more responsible system of U.S. housing finance.

The Private Mortgage Market Investment Act outlines many aspects of a robust regulatory framework. But in my view, these rules simply cannot be the government's only role in the mortgage market. In addition to a capable and empowered regulator, the market depends on a limited, explicit government guarantee to ensure liquidity, affordability, and equitable access for borrowers. I will discuss how we can achieve this later in this testimony.

Even if my colleagues on this panel and I disagree about the end goals of GSE reform, or what future role the federal government should have in the housing market, most of us can agree that government's role in the market needs to be reduced and private at-risk capital needs to play a far greater role. And many preliminary steps toward just about any new housing finance system are the same, as recently pointed out by former Treasury Assistant Secretary for Economic Policy Phillip Swagel.[1] These steps include setting new rules for the PLS market, setting an explicit price for any government guarantee, and narrowing the scope of mortgages eligible for government insurance.

Standardization is key, but must be done carefully

My colleagues and I seem to agree that standardization and transparency are necessary to give investors the confidence to begin investing in private mortgage-backed securities again. Establishing clear and reasonable regulations for the PLS market is a vital step forward.

Four years after the housing crisis began, investors are still slow to re-enter the PLS market. And for good reason: Years of excessive risk-taking and under-regulated lending as the housing bubble grew have shattered investor confidence in the private securities market.

In recent testimony before this subcommittee, the Association of Mortgage Investors identified several problems hindering private mortgage securitization today. These included a lack of standardization and uniformity, a "thorough lack of transparency," conflicts of interest, and "antiquated, defective, and improper" mortgage servicing.[2] These are rare instances in which both investors and homeowners agree that market reform is necessary.

As the GSEs take tentative steps toward pulling back their role, Congress must take meaningful strides toward restoring confidence on the private side by laying out clear rules for the game, which seems to be the primary focus of the Private Mortgage Market Investment Act.

I applaud the authors for making standardization and transparency a cornerstone of this bill. It tasks the Federal Housing Finance Agency with developing a standard model for securitization agreements, including explicit standards for pooling and servicing, purchase and sale, representations and warrantees, and indemnifications and remedies, based largely on models established by Fannie Mae and Freddie Mac. If done well, this will provide the clarity and protections necessary for investors to re-enter the market, one of the government's most important roles in the secondary mortgage market.

The bill tasks FHFA with prescribing broad risk classifications for mortgages, with the laudable goal of enabling a TBA market in which most agency mortgage-backed securities, or MBS, are sold today. Through this market, sellers agree to a future sale price but do not specify exactly which loans will be delivered to the buyer until a few days before the settlement date. Many market reform proposals, including our own, recognize the importance of maintaining this efficient forward market, which reduces costs and enables borrowers to know what rate they will be paying well before they get to the closing table.

The agency TBA market works because of homogeneity and scale. That homogeneity stems from several factors, including guaranteed cash flows of principal and interest, standardized underwriting and securitization practices, the fact that there are only two issuers, and the simplicity of the securities.[3] Many—but not all—of these factors can be replicated in the private market through the measures outlined in the bill.

One outstanding question is whether the classifications of loans proposed in the bill—as well as the inclusion of multiple private issuers into the market—will work against the liquidity and efficiency of the TBA market. Further, while investor transparency is critical, we must recognize that there is a trade-off between granularity of information and TBA market efficiency. These concerns would be exacerbated in a purely private market segment where MBS carry no federal guarantee. This example underscores a critical point—that we must move incrementally and that this bill does not offer a viable replacement for the GSEs.

Nonetheless, I agree it is time to get moving, test an approach such as this, and start building a new private mortgage market that is efficient and sustainable.

Classifying loans by product characteristics—also known a loan payment terms—is essential for evaluating both cash flows and credit risk, and should be moved front and center in the process of establishing risk classifications. Moreover, delivery channel is not mentioned but should be included in the top factors considered.

Research has confirmed that product and channel characteristics in and of themselves contribute to risk. Our research at UNC finds that prepayment penalties, adjustable interest rates, balloon payments, and broker origination substantially increase the likelihood of default even when controlling for borrower characteristics like credit score and loan-to-value ratio.[4] In fact, subprime loans were three to five times more likely to default than loans to comparable borrowers originated under a community reinvestment program.[5]

Research from the Federal Reserve Bank of San Francisco further supports the importance of loan characteristics, which found that higher-priced loans tripled the likelihood of foreclosure after controlling for borrower characteristics.[6] I particularly commend the proposal for demarking the 30-year fixed-rate mortgage category, which has been demonstrated to be a more sustainable mortgage and has been the building block for middle-class economic security in this country since its introduction in the 1930s.

However, the consideration of borrower-based criteria - debt-to-income ratio, loan-to-value ratio, and credit history - is problematic. The provisions in the bill on borrower-based risk criteria potentially raise many of the same problems as the regulators' proposed definition of so-called quality residential mortgages, or QRM, under the Dodd-Frank Act, which exempt certain loans from risk retention requirements. Namely, borrower-based underwriting rules risk excluding many creditworthy borrowers, or at least consigning them to high-cost loans.

Along those lines, I have specific concerns about each of the proposed cutoffs for borrower-based risk:

- *Debt-to-income ratio.* Intuitively, the ratio of debt payments-to-income, or DTI, would seem a good predictor of default risk; in practice, the ratio has been unreliable. The poor predictive power of DTI is because of several factors, including the fact that it is hard to arrive at a standard calculation, and it is highly variable over time even though cutoffs fall within a narrow range. DTI is neither precise, accurate, nor constant. Yet, in the risk retention NPR, FHFA notes that DTI ratios are the most restrictive factor within the proposed QRM definition.[7]

- *Credit history.* Following the example of the risk retention NPR, credit history thresholds should not be based on proprietary black-box scoring models, and should encourage lenders to review the actual credit history of borrowers. However, I am not aware of any evidence to support the proposed rigid single 60-day late exclusion. FICO finds that certain borrowers with credit scores in the 500 range would satisfy the standard, while others with scores over 800 would not. In fact, FICO estimates that 7.65 million consumers with FICO scores above 690 who got loans between 2005 and 2008 would have failed to meet the QRM credit history criteria.[8] Further, setting such a bar imposes disparate disadvantages on demographic groups, such as African Americans and Latinos, individuals younger than age 30, and recent immigrants.

- *Loan-to-value ratio.* The correlation between loan-to-value ratio and default is clearer than for debt-to-income. At the very least, higher equity provides a cushion so that when a borrower encounters an adverse event like income loss, the borrower can sell the home for at least enough to pay the mortgage and selling expenses, rather than default. However, there is ample evidence that high LTV lending can be done safely. And that's good news, because requiring borrowers to make 20 percent down payments would effectively shut down the housing market, at a time when 65 percent of borrowers put down less than 20 percent.[9] One such example is in the mortgage insurance sector, mentioned in bill as a factor the regulator should consider in creating loan classifications. There is evidence that loans with mortgage insurance had lower default rates and higher cure rates than low down-payment loans with purchase money seconds, even after controlling for a long list of risk factors.[10] [11] Moreover, mortgage insurers' countercyclical capital requirements encourage stockpiling of reserves in stronger markets to pay claims under weaker economic conditions.[12]

Despite the rhetoric of some, there are several examples of sustainable high LTV lending models. Here are a couple:

- *Self-Help's Community Advantage Program:* Since launching in 1998 by Self-Help in partnership with Fannie Mae and the Ford Foundation, this program has funded nearly 50,000 mortgages nationwide. The UNC Center for Community Capital has been studying this portfolio for nearly a decade.[13] The risk profile of these mortgages looks daunting, especially by today's standards: 39 percent had a credit score at origination of 660 or less and 80 percent of the borrowers put down less than 10 percent, including 69 percent who put down less than 5 percent. Yet to date, just 5.5 percent of the loans have ended in foreclosure for Self-Help, who retained recourse on the mortgages. Meanwhile, the median CAP owner has accumulated more than $16,800 in equity from origination through the first quarter of 2011.

- *Massachusetts Housing Partnership's SoftSecond Program:* Massachusetts Housing Partnership has operated the SoftSecond Loan Program since 1990, financing over 15,000 home purchases, typically at 97 percent LTV. The program targets households earning less than 60 percent of area median income. Yet, as delinquencies peaked in the summer of 2010, the SoftSecond program had a foreclosure rate of just 1 percent. For comparison, the foreclosure rate for prime loans in Massachusetts was 2.1 percent, and for subprime loans it was 13.6 percent.

Furthermore, soft second liens and other forms of bona fide down payment assistance should be favored - and certainly not penalized - by the proposed restrictions on second liens. These flexible loans can ensure successful homeownership experiences by preserving the liquidity of household financial assets, which is especially important for lower-income households in covering unexpected expenses that sometimes arise. A recent survey by the Center for Community Capital of 117 housing counselors nationwide found that 54 percent were seeing frequent use of soft second mortgages or down payment assistance programs.[14] These programs are important in today's fragile market

Borrower-related criteria for determining risk classifications are not always reliable determinants of defaults. But driving certain borrowers to costlier channels can increase the risk of default of those borrowers, simply by virtue of the loan terms and conditions. The last thing we want to do is repeat the mistake of consigning borrowers with fewer resources to higher risk, higher-cost products - or as former Federal Reserve Board Governor Ned Gramlich once put it, continuing a trend where "the most risky loan products [are] sold to the least sophisticated borrowers."[15]

Though it is unclear at this early stage how the categories will be set, it is clear that it will be a challenge to get right. There is real risk that the outcome duplicates or even worsens the problems raised by the QRM proposal, which have driven so much of the critique of the regulators' proposed risk-retention rule.

The goal of mortgage market reform should not be to partition the market and make some segments more expensive - and thus riskier - than others, but to ensure its sustainability in its entirety. That requires ensuring that sustainable loan products are the preferred option for creditworthy but less well-resourced borrowers, and proceeding with caution in creating multitrack markets. It also underscores why it is essential to approach reform incrementally and maintain the government support that's necessary to make the market work.

New consumer protections and transparency requirements are welcomed changes

While the bill does not directly address consumer protections, it does take steps to better serve investors, especially regarding servicer issues. Most servicing today is done within large financial holding companies, many of which have affiliates who hold second liens in the form of home equity loans and other products. This often leads to a compelling conflict of interest in which servicers of a mortgage also own the second lien—an arrangement in which consumers historically come third behind investors and servicers.

The bill establishes important consumer protections by prohibiting servicers from owning a second lien when they are servicing the first lien of the same mortgage. This will help restore consumer confidence in the PLS market by ensuring that servicers' other interests are not put before their duty to minimize investor losses.[16]

One notable question, however, is how the provisions on ex-post second liens will be implemented. I urge this subcommittee not to constrain the legitimate use of accumulated housing wealth for such purposes as paying for college education, forming a small business, or meeting major unplanned needs.

Moreover, as I previously noted, such provisions should favor the use of legitimate down payment assistance and soft-second mechanisms.

Another boost to consumer confidence comes from the bill's enhanced transparency and loan-level disclosure requirements. For too long investors in the PLS market were kept in the dark about the risks they were taking. Reliable information on product pricing and loan-level risk will force all market participants to do their business in the light of day, and help FHFA and other regulators mitigate fraud and abuse.

More granular loan-level information and standardization is critical to the re-emergence of a competitive and efficient private mortgage-backed securities market. The American Securitization Forum recognizes this in its Project on Residential Securitization Transparency and Reporting Restart, launched in July 2008, calling for loan level reporting of some 160 data points on each loan as well as new standards for bond-level reporting.[17]

To be sure, even with loan level data, product standardization, and correcting servicer/second-lien-holder conflicts, investors will still be exposed to principal-agent problems and other conflicts of interest.[18] Originators and issuers will still have access to greater information than investors can observe. Among the problems that will not be solved by provision of data is adverse selection—where originators/issuers may choose a different execution for loans they know to be of different risks. Moreover, detailed information does not assure that the right conclusions will be reached and the right decisions made. Weaknesses in the ratings process of the credit rating agencies [19] and the fact that investors and insurers misapplied sophisticated financial models [20] are well documented.

Despite these imperfections and unintended consequences, greater transparency in the PLS market is still a noble goal for Congress to pursue. And I believe the bill's current language is a helpful starting point to discuss how to strike the necessary balance of market efficiency and consumer protection.

However, investor transparency is not a perfect substitute for risk retention, which brings me to a concern.

Instead of repealing risk retention requirements, adapt a broad QRM standard

The bill would effectively strike down Section 941 of the Dodd-Frank Act by prohibiting the Office of the Comptroller of the Currency, the Federal Reserve, Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, and the Security and Exchange Commission from issuing any rule or regulation to require risk retention. This provision ratchets back more than a year of progress in bringing greater accountability to the mortgage market.

As mentioned above, the bill gives the regulator authority to develop representation and warrantee standards and remedies; I urge that these be meaningful and actionable, so that they do result in real accountability. Yet there can be no greater accountability than for agents to have a financial stake in the success of the loan. Even small amounts of risk retention can align the economic interests of borrowers and investors with the agents in between them while building some flexibility into the system.

But risk retention is a complex tool with a high potential for unintended consequences, as demonstrated by recent challenges faced while implementing Dodd-Frank over the past year. In commenting on the notice of proposed rulemaking implementing Dodd-Frank's risk-retention requirements, I urge regulators to reconsider applying risk factors that would greatly and disparately limit market access. Regulators should enact a broad definition of QRM.

Given the fragility of the current market, a broad QRM has the potential to restore access to credit more equitably, support broader homeownership and help the private market recover, without compromising systemic safety and soundness.

A key rationale for a broad QRM definition is that the future landscape of the mortgage market will be much less risky than the practices that prevailed in the mid-2000s. Any policy based on recent historic defaults should take into account the complementary regulations that will constrain the abusive lending that capsized the market. To name a few, the Federal Reserve used its authority to ban yield spread premiums based on selling higher-rate loans, and other forms of "steering" consumers into loans not in their best interests. The SEC recently proposed new rules to increase transparency and standardize credit analysis at rating agencies.[21] Dodd-Frank will bring greater regulation, standardization, and transparency to derivatives.[22] The Consumer Financial Protection Bureau will provide ongoing oversight of consumer financial products. And Section 1411 of Dodd-Frank creates a new minimum ability to repay standard for all mortgages.

Importantly, a broad QRM standard will go quite some ways toward addressing other concerns raised about the risk-retention proposed rule,[23] simply by greatly reducing the universe of non-QRM loans.

The Dodd-Frank Act is critical to moving toward a stable, fair, and responsible secondary mortgage market. The act identifies several key steps to safety and soundness and avoiding a similar debacle in the future. Those provisions should be preserved as is, and regulators should continue to translate the legislative text into reasonable and unambiguous rules.

Other provisions that should be reconsidered

The bill oversteps its intended goal of "ensuring the rule of law" by prohibiting any federal department or agency from requiring principal reduction for any securitized mortgage loan. With about 11 million properties currently underwater, roughly 22 percent of all U.S. homes, housing debt is one of the biggest drags on demand for goods and services in our economy.[24] Families that are underwater on mortgages are digging their way out of debt, not spending in stores. And the more low- and moderate-income families spend on housing, the less they spend on clothes, food, and other consumer goods, making businesses leery of investment.

To date, the number of principal reduction modifications has been miniscule. Large-scale principal reduction may be politically controversial, but it has enormous potential for stabilizing the leaden housing market and spurring broader economic growth. It is also well within the current regulatory powers of FHFA as the conservator of Fannie Mae and Freddie Mac. That's why many industry experts and prominent academics have called for some sort of principal reduction strategy, including current Chairman of the Federal Reserve Ben Bernanke,[25] former Fed Vice Chairman Alan Blinder,[26] and former Chairman of President Reagan's Council of Economic Advisers Martin Feldstein.[27]

To be sure, there are legitimate concerns with any principal reduction initiative, and such a program would have to be carefully crafted to limit potential losses to investors and taxpayers and manage moral hazard. But it would be unwise for Congress to prohibit any such program from seeing the light of day.

There's also a critical question of whether this prohibition applies just to new mortgage loans or to all existing loans, and whether it includes judicial modifications, which are currently allowed. The latter is especially relevant today, as principal write-downs are likely to be a key component of upcoming settlements between state attorneys general and mortgage servicers accused of faulty foreclosure practices.[28]

Another concern is the proposed changes to the Qualified Mortgage, which strike the rebuttable presumption approach in favor of the safe harbor approach. Regrettably, the events leading to the mortgage crisis made it necessary for Congress to mandate that lenders verify ability to repay when extending mortgage credit.

To avoid a repeat, it is in the best interest of borrowers and investors alike that the markets have accountability, which is better achieved through a rebuttable presumption with reasonable remedies, rather than through the immunity provided by a safe harbor. This is particularly true because the proposed safe-harbor approach does not even require lenders to consider such tried and true factors as employment status, debt levels, debt to income, and credit history. Under the rebuttable presumption, however, the lender still has the responsibility checking what is readily knowable, and proving they did so. With appropriate regulatory guidance, it need not be unduly burdensome to require lenders to make certain checks and to be accountable to investors for doing so.

I have significant concerns over any provision that would give blanket immunity given the lessons learned and the need to restore market confidence. It also seems to remove the CFBP jurisdiction to adjust QM rules, which should be reconsidered. A rebuttable presumption would signal to investors and consumers alike that this mortgage has been properly designed and underwritten; a safe harbor would not, thus defeating the purpose of the QM.

Unanswered questions

There are some provisions in the bill that need to be fleshed out before we can assess the possible impact on investors, borrowers, or the broader mortgage market. The draft only just became available, so we have not had a chance to complete a full assessment, but I raise these issues requiring further inquiry and discussion.

First, is the Federal Housing Finance Agency the best institution to head such a robust regulatory agenda, and what are the implications of reducing the role of the SEC and other agencies? To be sure, FHFA has dutifully fulfilled its mandate as regulator and conservator of Fannie Mae and Freddie Mac since 2008. But I see little evidence that the agency has the expertise or resources necessary to assess risk and loan quality for the notoriously complicated PLS market, which is almost certain to grow in the coming years.

Since the passage of the Dodd-Frank Act, the Security and Exchange Commission has made substantial changes to its regulatory framework for residential asset-backed securities. For example, the agency has proposed rules to prohibit conflicts of interest between securitizers and investors, beefed up disclosure requirements for issuers, and adopted new rules around representations and warranties.[29] Admittedly, FHFA is likely better suited to sort out the technical issues in the mortgage-backed security market, and well positioned to prevent the private-label market from destabilizing the other sectors as it did in 2007. But it would be a shame to see all this progress unwound as a result of this legislation.

Regardless of which agency is deemed suitable to regulate the PLS market, I urge Congress to incorporate the advancements made since enactment of Dodd-Frank, and to equip the agency with the resources, personnel, and systems necessary to carry out such a daunting and critical mandate. Moreover, Congress should not overlook the question of how to adequately fund the regulator to carry out this work.

Second, the bill mentions nothing about the multifamily mortgage market. It is projected that the shortage in affordable rental housing is only going to be exacerbated in the wake of the foreclosure crisis. Over the next 30 years, we may need to add more than 40 million new housing units of all types to meet the demand. We cannot get on track without a strong rental housing finance system. If this bill were to be enacted, how would the multifamily market continue to operate, particularly if the GSEs are wound down?

Finally, it's unclear to me how the authors intend this bill to fit into other proposals for GSE reform currently under consideration in the subcommittee. The House majority has drafted 15 bills to wind down different aspects of Fannie Mae and Freddie Mac's current business, and industry experts and notable academics have proposed a bevy of other policy alternatives. Is this bill intended to work in tandem with these other bills? Or is it simply intended to replace the current GSE model, leaving the federal government with only a regulatory role in the mortgage market? The language in the bill does not explicitly say.

If this is indeed intended to replace the GSE model, there appear to be many gaps in the regulatory coverage, which I address in more detail below.

Next steps toward a more responsible market for housing finance

As mentioned above, with some substantial changes this bill marks an important first step toward broader GSE reform. But it cannot be the only step. While standardization and transparency are essential to a well-functioning U.S. mortgage market, they are not enough. Our Mortgage Finance Working Group proposal is built on five key principles: liquidity, stability, standards and transparency, affordability, and consumer protection.

Any new system of mortgage finance must be based on lessons learned in the past. History has shown us that a housing finance system left to private markets will be subject to a level of volatility that is not systemically tolerable, given the importance of housing to the economy and to the American family.

The past decade exposed serious flaws in our housing finance architecture.[30] The availability of mortgages was wildly cyclical, resulting in excessive mortgage credit during the housing boom, followed by a nearly complete withdrawal of credit when the bubble burst. The risk of many of the mortgages originated during the housing bubble was underpriced. At the same time, these mortgages were not sustainable for consumers, as low teaser rates and opaque terms masked their high overall cost.

The housing bubble was driven by the development of a "shadow banking system" in which mortgage lending and securitization was largely unregulated and certainly undisciplined. In time, this system drew in the quasi-governmental entities Fannie Mae and Freddie Mac who increased their own overall risk during the "race to the bottom" that implicated almost all mortgage lenders during the 2000s. In particular, as Fannie Mae and Freddie Mac lost market share to private mortgage-backed securities issuers who were underpricing risk, the two mortgage finance giants lowered their own underwriting standards and increased their leverage in an attempt to compete. The result: Taxpayers were left exposed to major losses. The new system must be designed to avoid the same pitfalls in the future.

Five principles of a new system of U.S. housing finance

First, there must be broad and constant liquidity. The new system needs to provide investors the confidence to deliver a reliable supply of capital to ensure access to mortgage credit for both rental and homeownership options, every day and in every community, during all kinds of different economic conditions, through large and small lenders alike.

Broad and constant liquidity also requires effective intermediation between borrower demands for long-term, inherently illiquid mortgages and investor demands for short-term, liquid investments. The capital markets have therefore come to play an essential role in mortgage finance. But as the past decade so stunningly demonstrated, left to their own devices, capital markets provide highly inconsistent mortgage liquidity, offering too much credit sometimes and no credit at other times with devastating effects on the entire economy.

Second, any new system must foster financial stability. Stability is achieved by reining in excessive risk-taking and promoting reasonable products and sufficient capital to protect our macro economy and household economies from destructive boom-bust cycles. A totally private mortgage market is inherently inclined toward extreme bubble-bust cycles, which cause significant wealth destruction that brings with it devastating repercussions not only for homeowners and lenders but also for neighborhood stability, the larger financial system, and the broader economy.

Private mortgage lending is inherently procyclical. As we saw in the previous decade, capital arbitrage can quickly turn small gaps in regulatory coverage into major chasms, causing a "race to the bottom" that threatens the entire economy. Stability for the market requires sources of countercyclical liquidity even during economic downturns.

Third, transparency and standardization will support these other principles. Underwriting and documentation standards must be clear and consistent across the board so consumers, investors, and regulators can accurately assess and price risk and regulators can hold institutions accountable for maintaining an appropriate level of capital. During the housing bubble, the housing finance system experienced a seismic shift toward complex and heterogeneous products that could not be understood by consumers at one end of the chain to securities that could not be understood by investors at the other. The lack of transparency and standardization set the stage for adverse selection because the issuers knew more than the investors.

Because the state of the whole secondary market affects the pricing of each packaged pool of mortgages in it, a safe and liquid securitization market can only exist if investors have access to information about all mortgage-backed securities in the marketplace. A private mortgage-backed securities market will not reemerge unless investors are convinced these issues have been resolved. Secondary market transparency and standardization lower costs and increase availability. And for borrowers, standardization and transparency mean that they can make good choices from among well-understood and standard mortgage products.

Fourth, the system must ensure access to reasonably priced financing for both homeownership and rental housing. Liquidity and stability are essential to affordability and, for most families, the lower housing costs produced by the modern mortgage finance system over the past half century (before the recent crises) facilitated wealth building, enabling them to build equity, save, and invest. This contributed to the building of a strong middle class and has been an important guiding concept in modern U.S. housing finance policy—and a key component of the American socioeconomic mobility of the 20th century.

A pillar of this housing system is affordably priced long-term, fixed-rate, fully self-amortizing, pre-payable mortgages, such as the 30-year mortgage. The long term of this loan provides borrowers with an affordable payment while the fixed-rate, the option to prepay, and self-amortization features provide the financial stability and forced savings that are critically important to most families, while retaining the opportunity for mobility. In the absence of government policies designed to explicitly support long-term, fixed-rate mortgages, it is likely that this type of mortgage would largely disappear from the U.S. housing landscape or become unaffordable to the nation's middle class, which has been so effectively served by 30-year residential mortgages, and to the nation's many renters who rely on multifamily property owners' ability to finance and refinance their apartment buildings.

A responsible plan recognizes the interdependency of all segments of the mortgage market and calls for a coherent array of government supports—from regulations and standards to limited security guarantees to loan guarantees to subsidies to direct funding. We have learned the lesson of how failures in one sector—for example, the private-label market—spill over into the other sectors. Likewise, we know that when one particular segment functions well, it can have positive spillover for the rest of the market. For example, sustainable affordable lending creates a strong and accessible housing ladder today that means a strong move-up market tomorrow. Therefore, it is in the interest of all segments to support activities that create sustainable rungs on that ladder. Moreover, government oversight will facilitate efficiency and liquidity in the "pure-private" market, resulting in economic benefits to investors, lenders, and consumers in this market, and these benefits should be taken into account.

Finally, the system must support the long-term best interest of all borrowers and consumers and protect against predatory practices. The purchase of a home is a far more complicated, highly technical transaction than any other consumer purchase and occurs only a few times in a consumer's life. Mortgage consumers are at a severe information disadvantage compared to lenders. In addition, a mortgage typically represents a household's largest liability. A mortgage foreclosure therefore has outsized consequences for the borrower. As the current crisis so sadly demonstrates, mortgage foreclosures also deliver devastating consequences to communities, the financial markets, and the broader economy.

During the housing boom, unregulated and often predatory subprime lending not only failed to maintain or promote sustainable homeownership opportunities but also established a dual credit market where factors other than a borrower's creditworthiness—such as race or neighborhood location—determined the type and terms of the mortgages available. All too often, families were denied the best credit for which they qualified because their communities were flooded with unsustainable mortgage credit—in part because secondary market pressures created incentives to make and sell these loans instead of the safer, lower-cost products.

The Mortgage Finance Working Group's plan

The Private Mortgage Market Investment Act takes noteworthy strides toward the third principle: transparency and standardization. After improving and passing this bill, it'll be time to move on to the other four.

The Mortgage Finance Working Group's "Plan for a Responsible Market" strikes the necessary balance between private investment and government support in the secondary mortgage market.

First, we call for a larger role for a pure private market, one that will serve those borrowers who have the resources to access mortgage capital under reasonable terms and conditions without any support - other than regulatory protections - from the government.

For the middle market, our proposal creates a system that preserves the traditional roles of originators and private mortgage insurers but assigns functions previously provided by Fannie Mae and Freddie Mac to three different actors—issuers; chartered mortgage institutions, or CMIs; and a catastrophic risk insurance fund, or CRIF.

Issuers will originate or purchase and pool loans, issue MBS, and may purchase credit insurance on MBSs that meets certain standards from CMIs. CMIs also will be fully private institutions not owned or controlled by originators. They will be chartered and regulated by a federal agency and their function would be to assure investors of timely payment of principal and interest only on MBSs that are eligible for the government guarantee.

The CRIF would be an on-budget fund (similar to the FDIC's Deposit Insurance Fund) that is run by the government, and funded by premiums on CMI-guaranteed MBSs. In the event of the CMI's financial failure, the explicit guarantee provided by the CRIF would protect only the interests of holders of only qualified CMI securities.

The government would price and issue the catastrophic guarantee, collect the premium, and administer the fund. The fund would establish the product structure and underwriting standards for mortgages that can be put into guaranteed securities and the securitization standards for MBSs guaranteed by the CMIs. The government would also establish reserving and capital requirements for CMIs, and these would be at higher levels than those held by Fannie and Freddie.

It is important to note that under our plan, private capital would play a far greater role, with the government role restricted to filling in gaps where needed to ensure each market section can function efficiently. For the traditional conforming conventional market, there would be several layers of protection standing ahead of any taxpayer exposure. Borrower equity, the CMI's capital, and in some cases private mortgage insurance all would stand ahead of the CRIF. All of these private sources of funds would need to be exhausted before the CRIF would have any exposure to loss. We believe this system will serve the needs of the vast majority of households that are looking for the consistent availability of affordable credit and predictable housing costs that can be achieved through a limited government market backstop.

I believe that many aspects of the regulation of private-label securities under the Private Mortgage Market Investment Act align with the Mortgage Finance Working Group's model for the future. At the very least, the bill lays out the rules for the private-label security market, in which issuers would package and sell MBSs without a government guarantee. With some minor modifications, these rules can also govern the activities of the newly-chartered CMIs.

In closing, I would like to commend the chairman and the other members of this subcommittee for holding this hearing. As Congress and the administration work to design a better system of housing finance for the future, it's critical to make sure the rules of the game are laid out clearly and fairly before anyone can be expected to start playing again. I believe the Private Mortgage Market Investment Act as drafted is a helpful starting point for negotiating those rules, but it must be seen as only a first step toward broader GSE reform. I would be happy to take any questions.

Janneke Ratcliffe

Janneke Ratcliffe is a Senior Fellow at American Progress, where her work focuses on using research in the area of housing finance to inform policy and practice. Since 2005, she has served as associate director for the Center for Community Capital at the University of North Carolina-Chapel Hill, a research center dedicated to exploring ways to increase economic opportunity for undercapitalized communities that are effective in building assets and sustainable from a business perspective.

She has 20 years of experience in nonprofit and for-profit financial institutions, from GE Capital to one of the country's leading community development financial institutions. Through her work in mortgages, business lending, and community development finance, she has built expertise in facilitating the flow of financial services to households and communities.

ENDNOTES

[1] Phillip Swagel, "The Future of Housing Finance Reform," School of Public Policy, University of Maryland, October 2011. Available at http://www.bos.frb.org/economic/conf/LTE2011/papers/Swagel.pdf.
[2] Lieberman, Jonathan, Agnelo, Gordon & Co., "The State of Securitization Markets," Written statement on behalf of the Association of Mortgage Investors before the US House of Representatives Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, September 6, 2011.
[3] James Vickery and Joshua Wright, "TBA Trading and Liquidity in the Agency MBS Market," Federal Reserve Bank of New York Staff Report no. 468, August 2010, available at http://www.ny.frb.org/research/staff_reports/sr468.pdf.
[4] Roberto G. Quercia, Michael A. Stegman, and Walter R. Davis, "The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments," *Housing Policy Debate*. 18.2 (2007), 311-346.
[5] Lei Ding, Roberto G. Quercia, Wei Li, and Janneke Ratcliffe, "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models," *Journal of Real Estate Research*. 33.2 (2011).
[6] Elizabeth Laderman and Carolina Reid, "Lending in Low- and Moderate-Income Neighborhoods in California: The Performance of CRA Lending During the Subprime Meltdown," Federal Reserve Bank of San Francisco, 2008, Working Paper 2008-05.
[7] Federal Housing Finance Agency, "Mortgage Market Note 11-02," April 11, 2011.
[8] Michael Calhoun and Ellen Harnick, "RE: Interagency Proposed Rule on Credit Risk-retention," August 1, 2011, available at http://www.sec.gov/comments/s7-14-11/s71411-279.pdf
[9] National Association of Realtors, "REALTORS® CONFIDENCE INDEX," September 2011, available at http://www.realtor.org/wps/wcm/connect/ee5aa50048d8797f9246de2e39654e23/RCI201109_pdf.pdf?MOD=AJPERES&CACHEID=ee5aa50048d8797f9246de2e39654e23
[10] Genworth Financial, Genworth Mortgage Insurance Company Public Comment on Credit Risk Retention Rule, July 28, 2011 available at http://www.regulations.gov/#!documentDetail;D=OCC-2011-0002-0216.
[11] Promontory Financial Group, "Assessing the Delinquency and Default Risk of Insured and Non-Insured High LTV Mortgages," July 12, 2011.
[12] See for example, Janneke Ratcliffe, "The Role of Private Mortgage Insurance." Statement before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, U.S. House of Representatives; Hearing on Future of Housing Finance: The Role of Private Mortgage Insurance. July 29, 2010; And Promontory Financial Group, "the Role of Private Mortgage Insurance in the U.S. Housing Finance System." January 2011. http://www.promontory.com/assets/0/78/110/286/974d1fb8-ac46-413e-a62a-4b5472f4df14.pdf
[13] Roberto G. Quercia and Janneke Ratcliffe, "GOOD BUISNESSS AND GOOD POLICY: Finding the Right Ways to Serve the Affordable Mortgage Market," Community Advantage Panel Study Policy Brief, July 2009, available at, http://www.ccc.unc.edu/documents/CAP_Policy_Brief_July09.pdf.
[14] This survey is part of forthcoming research from the UNC Center for Community Capital. Feel free to contact the Center for further information (see www.ccc.unc.edu).
[15] Edward M. Gramlich, "Booms and Busts: The Case of Subprime Mortgages" (Washington: The Urban Institute, 2007), available at http://www.urban.org/UploadedPDF/411542_Gramlich_final.pdf.
[16] Peter Swire, "What the Fair Credit Reporting Act Should Teach Us About Mortgage Servicing: Progressive Recommendations to Protect Home Mortgage Consumers" (Washington: Center for American Progress, 2011) http://www.americanprogress.org/issues/2011/01/fcra_mortgage_servicing.html
[17] ASF Project Restart, "Disc losure and Reporting Package Final Releases; Representations and Warranties Request for Comment" (July 2008) See http://www.americansecuritization.com/story.aspx?id=3461.
[18] Lori Goodman, Roger Ashworth, Brian Landy and Lidan Yang, "The Elephant in the Room--Conflicts of Interest in Residential Mortgage Securitizations," Amherst Securities Group LP, May 20, 2010.
[19] United States Securities and Exchange Commission, Summary report of issues identified in the commission staff's examinations of select credit rating agencies, July 8 2008,available at http://www.sec.gov/news/studies/2008/craexamination070808.pdf.

[20] Catherine Donnelly and Paul Embrechts, "The Devil is in the Tails: Actuarial Mathematics and the Subprime Mortgage Crisis," RiskLab, ETH Zurich, Switzerland, p14, 2010.
[21] United States Securities and Exchange Commission, "SEC Proposes Rules to Increase Transparency and Improve Integrity of Credit Ratings," Press release, May 18, 2011, available at http://www.sec.gov/news/press/2011/2011-113.htm.
[22] Board of Governors of the Federal Reserve System, "2010 Banking and Consumer Regulatory Policy," Press release, August 16, 2010, available at http://www.federalreserve.gov/newsevents/press/bcreg/20100816d.htm
[23] These concerns include that QRM and non-QRM loans cannot be comingled efficiently, and that the premium capture cash reserve account provisions may make non-QRM securitization nonviable.
[24] Jon Prior, "More than 22% of mortgages still underwater," September 13, 2011 available at http://www.housingwire.com/2011/09/13/more-than-22-of-mortgages-still-underwater
[25] Chairman Ben S. Bernanke, "Reducing Preventable Mortgage Foreclosures," Speech at the Independent Community Bankers of America Annual Convention, Orlando, Florida, March 4, 2008 Available at www.federalreserve.gov/newsevents/speech/bernanke20080304a.htm
[26] Alan S. Blinder, "How to Clean Up the Housing Mess," *The Wall Street Journal,* October 20, 2011, available at http://online.wsj.com/article/SB10001424052970204485304576640983793571772.html
[27] Martin S. Feldstein, "How to Stop the Drop in Home Values," *The New York Times,* October 12, 2011, available at www.nytimes.com/2011/10/13/opinion/how-to-stop-the-drop-in-home-values.html
[28] Alon Cohen, "New Source of Mortgage Mediation Funds: Seeing Success, States Are Adding and Expanding Mortgage Foreclosure Mediation Programs—Something the State AG Settlement Should Support" (Washington: American Progress 2011) http://www.americanprogress.org/issues/2011/05/mortgage_mediation.html.
[29] US Securities and Exchange Commission, "Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act — Accomplishments," available at http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml#abs
[30] Markus K. Brunnermeier, "Deciphering the Liquidity and Credit Crunch 2007-08," Journal of Economic Perspectives 23 (1) (2009): 77–100.

American Enterprise Institute
for Public Policy Research

Statement before the House Financial Services Committee
Subcommittee on Capital Markets and Government Sponsored Enterprises
On the Private Mortgage Market Investment Act

Why and How to Revive the Private Securitization of Mortgages

Peter J. Wallison

Arthur F. Burns Fellow in Financial Policy Studies

American Enterprise Institute

November 3, 2011

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Testimony to House Financial Services Committee

Subcommittee on Capital Markets and Government Sponsored Enterprises

Peter J. Wallison

Arthur F. Burns Fellow in Financial Policy Studies
American Enterprise Institute

November 3, 2011

Chairman Garrett and Ranking Member Waters. Members of the Committee. I appreciate the opportunity to testify before this subcommittee today on ways to revive the private securitization market.

This is an important subject for several reasons that go well beyond housing. First, the United States is in the midst of a major effort to cut its national debt, which is already close to $14 trillion; according to the Congressional Budget Office, the debt will reach $23 trillion in 2021 if current policies continue. One component of that debt—off-budget and not included in the $23 trillion figure—are the obligations of the government-sponsored enterprises Fannie Mae and Freddie Mac.

Too many people around Washington, and too many self-interested parties, want to put the government and the taxpayers needlessly on the hook for yet more debt in support of the housing system. As a result of the high loan limits and the suppression of private securitization through the obstacles and disincentives listed below, approximately 90% of all originations and 99% of all securitizations are now government guaranteed. This is an ongoing liability for the taxpayers and an unhealthy fiscal position for the United States.

Further, creating more government-backed paper to finance the housing market turns out to be yet another way to assess the taxpayers. Government-backed mortgage paper competes with Treasury securities of equal maturity, and thus raises the interest rate that the Treasury has to pay on its own debt—another cost borne by the taxpayers. It's difficult to be exact about how much this might be, but a recent Fed study concluded that the Fed's purchase of mortgage-backed securities (MBS) issued by the government-sponsored enterprises (GSEs) lowered the cost of the Treasury's 10 year note by 30 to 100 basis points by taking the GSEs' competitive paper off the market. If this is accurate, the savings for the government and the taxpayers of going to a fully private housing finance market would amount to billions of dollars.

Instead of adding to the debt, we should be looking for ways to reduce the government's obligations. One of the ways to do that is to reduce the government's role in the housing market by turning as much as possible over to the private sector. This should not be considered a radical idea. The private sector finances virtually everything else in the US economy, and why it should do special favors for the housing industry in particular has never been apparent. After the financial crisis of 2008, which was brought about by the government's housing policy, it is remarkable that we are still wrestling with the question of whether and how to get the government out of this business.

In addition, private institutional investors—insurance companies and pension funds among them—badly need mortgages and mortgage-backed securities for investment. They are not major investors in GSEs securities—about $1.8 trillion out of total investments of $13 trillion—because the yields are too low. Instead, they are investing in corporate securities—even junk bonds—in order to obtain the yields they would get from good quality mortgages and MBS. These instruments would be liquid, high quality and relatively long term investments that would enable these long-term investors to diversify their holdings. They would be healthier and safer, and America's homeowners would have an immense and steady source of capital for their mortgage needs. This is a win-win for this country if ever there was one.

Finally, there could not be a better introduction to the need for the legislation this committee will consider today than a recent statement by former Fed chair Paul Volcker:[1]

> There is one very large part of American capital markets calling for massive structural change that so far has not been touched by legislation. The mortgage market in the United States is dominated by a few government agencies or quasi-government organizations. The financial breakdown was in fact triggered by extremely lax, government –tolerated underwriting standards, an important ingredient in the housing bubble. The need for reform is self-evident and the direction of change is clear. We simply should not countenance a residential mortgage market, the largest part of our capital market, dominated by so-called Government-Sponsored Enterprises.
>
> The residential mortgage market today remains almost completely dependent on government support. It will be a matter of years before a healthy, privately supported market can be developed. But it is important that planning proceed now on the assumption that Government-Sponsored Enterprises will no longer be a part of the structure of the market.

Planning now for the time when government-sponsored enterprises are no longer part of the structure of the housing market is precisely what this committee is doing today.

Reviving a Private Securitization Market

Reviving the private securitization system is necessary to finance large sectors of the housing market that are not served today, and would not be served in the future, by any government-backed system. There are not enough lendable funds in the banking sector to finance all the mortgages in the US, so we must rely on a supplementary system. Securitization of prime mortgages in the past has shown itself to be an efficient way to increase the funds available to the housing market. Other nongovernmental options, such as covered bonds, are available, but private securitization is a proven way to expand investment in home ownership.

Reviving the private housing finance system will be a daunting task, with many moving parts. Two things must be done in tandem. First, the GSEs must gradually be withdrawn from the market. The private sector cannot restart if they have to compete with—or believe they will have to compete with--government-backed entities. At the same time, changes must be made in existing laws and regulations that will encourage the entry of private sector securitizers and stimulate the interest of investors. Right now, in addition to the existence of the GSEs, there are a large number of impediments and disincentives that are keeping private firms from entering the

[1] Paul A. Volcker, The William Taylor Memorial Lecture, September 23, 2011, p11.

securitization market. If these are removed, I believe that private organizations will eagerly enter the field.

In this testimony, I will outline the necessary steps revive the private securitization market. Following that discussion, I will review the terms of the legislation introduced recently by Chairman Garrett.

I. Reducing the Costs and Increasing the Incentives of Securitizers

When a bank or other originator has made or acquired a mortgage loan, it has a number of alternatives. It can combine the loan with others, create a pool of loans, and sell them to investors in securitized form; it can insure the loan with the Federal Housing Administration (FHA) and create a Ginnie Mae security, sell it to Fannie or Freddie for a GSE pool, or finance it with deposits or with a loan from one of the Federal Home Loan Banks.

Each of these options entails a combination of risks and rewards, so if we want to encourage banks and others to assemble and sell private mortgage backed securities it is necessary to make that option advantageous in relation to the government agency options. To do that means creating financial incentives for securitization as well as removing risks and other disincentives. Outlined below are several items in current law or existing or proposed regulations that would tend to discourage originators from securitizing their mortgages, and thus to discourage the revival of private sector securitization in general.

Many of the disincentives below were created by the Dodd-Frank Act (DFA) itself, or the by regulations proposed thus far under the DFA. Thus, it should not be surprising that the private securitization market has not revived since the financial crisis of 2008. The DFA, enacted in the wake of the financial crisis, has done much to suppress and discourage the development of a private securitization market.

1. **High GSE and FHA conforming loan limits**. Currently, as directed by the Housing and Economic Recovery Act of 2008, the GSE loan limits have been reduced to $625,500, and FHA's limit to an equivalent level. These very high limits reduce the number of mortgages that are available for private securitization. One of the most important ways that Congress can revive a private securitization market would be to continue the trend, begun on October 1, to reduce the conforming loans limits of the GSEs and FHA. This can be done in stages, perhaps over five years, but it must be embodied in a law, so that private securitizers will have confidence that if they make the necessary investments there will be a large enough private market to make their investment worthwhile.

In addition, one of the reasons that the GSEs are able to outcompete private securitization is the fact that they have not in the past received compensation for the risks they were taking. Since their insolvency in 2008, it has become apparent that these risks were there, but well hidden. As the obstacles to private securitization are removed, FHFA should maintain guarantee fees and loan level risk adjustments that fully compensate the GSEs—and the taxpayers who own them—for their risks.

2. **Risk-retention and capital**. The provisions of the DFA that mandate a 5 % risk-retention for mortgage securitizers were originally intended to work in tandem with a requirement for a good quality mortgage, which was called the Qualified Residential Mortgage

or QRM. The QRM was supposed to be a prime mortgage—not necessarily a bullet-proof mortgage—and the 5% risk-retention was supposed to be a penalty for not securitizing prime mortgages. That idea was lost as the regulations were developed, and the most recent proposed regulations—which mandated a 20 percent downpayment as part of a QRM—have been uniformly panned by the industry.

Minimum standards for mortgage quality make sense, but the risk-retention idea does not. As proposed, it would not prevent the origination of subprime or other low quality mortgages, and it would entail considerable capital costs for securitizers of mortgages that did not meet the very high QRM standard that the regulators proposed. Indeed, only the largest banks would have balance sheets large enough to retain these 5% slices over the many years required by the regulation. The prospect of incurring these capital costs is one of the items that is discouraging potential securitizers. It creates a strong incentive to sell loans to the GSEs or FHA rather than securitize them. As outlined below, a version of the QRM—that is, a minimum standard for securitized mortgages—should be retained, but the 5% retention requirement should be repealed.

3. FHA and GSE exemption from risk-retention. The DFA exempts FHA from the 5% risk-retention, and the initial proposed regulations under the DFA would also exempt Fannie and Freddie. As a result, each of these agencies will be able to securitize mortgages—even prime mortgages that do not meet the narrow QRM standard initially proposed by the regulators—at lower cost than any private firm. Accordingly, it would be extremely difficult for private firms to enter the securitization field while this provision exists, and few will be willing to do so. If it wants to stimulate the return of private securitization, Congress should repeal the 5% risk-retention. Its existence creates competitive advantages for Fannie, Freddie and FHA vis-à-vis private securitizers that present a virtually insuperable obstacle to the revival of a robust private securitization market.

4. Risk-retention and true sale. Another reason to repeal risk-retention is that it jeopardizes the ability of securitizers to get true sale (and thus off-balance sheet) treatment for securitizations under existing accounting rules. True sale treatment is available if the securitizer has transferred all liability. The proposed regulation offers four options, but only the vertical slice clearly qualifies for sale treatment, because the 5% retained in that case matches the risk profile of the pool. However, the vertical option does not represent a significant risk, and thus will not create a disincentive to making subprime loans. Accordingly, the one risk-retention method that qualifies for true sale treatment vitiates the intended purpose of the 5% risk-retention idea. For this reason alone, risk-retention should be repealed. As discussed below, mortgage quality would then be maintained by a regulation that specifies the requirements for one or more categories of prime loans.

5. The FDIC's safe harbor. The FDIC's safe harbor regulation adds new provisions and conditions for determining whether a bank has properly divested itself of a pool of mortgages in a securitization. If so, the FDIC waives its right as receiver of a failed bank to reclaim the mortgages from the securitization. But the rule is immensely complex, and involves meeting some ambiguous quality standards. Whether these complex requirements will comply with the accounting rules, and whether the FDIC will agree that various quality requirements have been met, are open questions that substantially increase the risks of a securitization transaction. Under these circumstances, few banks will proceed with a securitization. This impediment to securitization can be eliminated by requiring the modification of the FDIC's rule so that the risk that the FDIC will intervene in a securitization to reclaim assets is effectively eliminated.

6. SEC's Regulation AB. This proposed regulation is intended to implement section 621 of the Dodd-Frank Act, which prohibits, among other things, securitization sponsors from engaging in transactions that involve a conflict of interest with investors in the securitization. If such a conflict of interest exists—and in theory it always exists between a buyer and a seller—the transaction can be rescinded. Therefore, before a bank or other issuer can engage in a securitization, it has to know that it will be complying with the DFA and proposed Regulation AB. Until the regulation is finalized, it will be very difficult for a securitizer to know whether it is complying with the DFA, and afterward it may not be possible for certain kinds of securitizations to be done. Accordingly, potential securitizers may not be willing to invest in the necessary resources to engage in this business, or will simply sell their loans to the GSEs, until there is certainty in this area. Legislation should make clear what specific transactions were meant to be covered, or the section 621 of the DFA should be repealed.

7. **Premium cash recapture**. The proposed regulations on premium cash recapture under the DFA also discourage securitization by substantially reducing the economic returns to securitizers. In some subprime securitizations a substantial spread between what the borrower paid and what the investor received was built into the transaction. There was concern that this spread was then used to compensate originators for delivering loans with higher interest rates than the borrower might have qualified for. To prevent this, the regulators seeking to implement the DFA's provision required the entire spread to be retained until all proceeds have been paid to the investors. In this position, it amounts to a risk-retention of some size and may jeopardize the availability of true sale accounting treatment. Although intended to address predatory lending, this provision would prevent securitizers from realizing the economic benefits of the spread even when they are securitizing prime mortgages. If they tried to make up this loss with a higher interest rate, they would be even less competitive with the GSEs. This provision should be modified so that it doesn't apply to prime mortgage securitizations.

8. Volcker Rule. Although justified as preventing the use of insured deposits for risky trading, this rule, enacted in the DFA, prohibits "bank related entities" from engaging in proprietary trading and thus extends far beyond the insured banks it was intended to cover. The term "bank related entities" includes bank holding companies and their subsidiaries, which do not have access to insured deposits. In addition, "proprietary trading" is so difficult to define that the most recent draft regulation covers almost 200 pages and poses over 1000 separate questions to assist the regulators in drafting the final rule. Hedging is a regular and important element of every securitization because it is necessary to protect the issuer against a change in interest rates between the time a mortgage rate is "locked in" with the borrower and the time a complete pool can be assembled for a securitization. Hedging transactions involve buying and selling of securities for the issuer's own account, and could be interpreted to be proprietary trading. Until there is a bright line definition of proprietary trading, it is unlikely that many banks or bank-related entities will take the risk of engaging in a securitization. It is unlikely that the complexity associated with proprietary trading can be adequately defined in a statute, and it may not be possible to define it clearly enough in a regulation. Accordingly, the Volcker Rule may stand permanently as a serious obstacle to private securitization. There are two ways to solve this problem: repeal the Volcker Rule, or apply it solely to insured banks and not the broader "bank-related entities." This will enable bank holding companies and their affiliates to engage in securitization without fear of violating the highly technical Volcker Rule when the regulation is ultimately finalized.

9. Qualified mortgage. The DFA also contains a concept called a Qualified Mortgage (QM), which is defined roughly as a mortgage that a borrower can afford. There are a number of severe consequences for providing mortgage credit to a borrower who could not afford to meet the obligations on the loan, the most significant of which is that a violation of the QM requirements can serve as a defense to foreclosure. This penalty extends to the investor as well as the securitizer, and could be mitigated if there were an effective safe harbor in either the DFA or the proposed regulation, but there is not. Without a clear and unambiguous safe harbor, this provision is a strong disincentive for anyone to securitize or acquire a mortgage.

10. Basel 3. Mortgage servicing rights (MSRs) are an important part of the securitization process, and an important part of the compensation that securitizers receive. Current accounting rules require that MSRs be capitalized and amortized over time. The new Basel rules on bank capitalization place a limit of 10 percent on the use of MSRs in computing tier 1 capital. This substantially reduces the value of MSRs to any financial institution covered by the Basel requirements. It also creates a number of other difficulties, the most important of which is an incentive on the part of any bank originator to sell its mortgages to the GSEs or FHA with servicing released. This problem will be difficult to address, because neither the accounting rules nor Basel 3 are easily changed. However, the loss of value of MSRs for capital purposes may not be an obstacle to securitization if the other impediments and disincentives listed above are removed. Banks that are bound by Basel 3 may be able to sell the MSRs separately or make up the regulatory capital cost another way.

II. Facilitating a Robust Private Securitization Market

Even if all the obstacles and disincentives listed above are eliminated, the private securitization market could be substantially improved and made more efficient.

1. Prime mortgage definition. Instead of a 5% risk-retention, which as defined in the proposed regulation will be ineffective in preventing the future growth of another subprime market, Congress should authorize the Federal Housing Finance Agency (FHFA) to recommend one or more mortgage formats or categories that would be considered prime mortgages. These mortgages, which would have a mixture of minimum downpayments, credit scores, debt-to-income ratios, loan terms and loan purposes—and could include mortgage insurance as additional credit enhancement—would be the only mortgages eligible for securitization. This would allow securitizers of all sizes—not just those that have balance sheets sufficiently large to carry the 5% retention—to engage in securitization of prime mortgages. It would also lower the cost of securitization. In order to stimulate the development of a To Be Announced (TBA) market over time, the number of such prime categories should be kept small enough to create the liquid private securities market that would permit TBA-based hedging.

2. Securities law exemption. In order to facilitate the growth of a TBA market in privately issued securities, the SEC should specify the disclosures that will be required in prospectuses and other selling documents and make them eligible for "shelf" registration.

3. Uniform securitization agreements. Just as Fannie and Freddie helped to create a more liquid secondary mortgage market by requiring a standard form of mortgage, FHFA should be directed to create standard forms for securitization documentation, including representations and warranties; mandatory arbitration of disagreements among issuers, servicers and investors; standardized servicer accounting; standardized reporting to investors on modification or workout of loans; and provisions for the appointment of a special trustee for investors where the servicer has a conflict of interest with investors.

III. Reducing Costs and Eliminating Impediments for Institutional Investors

Just as there are impediments and disincentives for banks and others to engage in securitization, there are also costs, impediments and disincentives for institutional investors to purchase MBS. Any effort to revive a securitization market should entail the elimination of these difficulties. The private institutional investor market—consisting of insurance companies, pension funds and mutual funds—includes at least $13 trillion that could be invested in fixed income securities such as privately issued MBS. Since Fannie and Freddie came to dominate the secondary mortgage market—keeping many of the gains and reducing yields—private institutional investors have not been major buyers of MBS. Only $1.8 trillion was invested in GSE securities in 2010; the balance apparently goes to corporates, including lower quality securities that involve more risk but produce the higher yields that institutional investors need. Enabling institutional investors to invest in MBS would improve their diversification and stability, as well as increasing the available funding for the housing market.

1. The Qualified Mortgage. As noted above, the QM created by the DFA creates potential liabilities for securitizers by giving borrowers a defense against foreclosure. The same factor creates potential losses for investors in MBS backed by mortgages that are subject to the QM. Until there is a much clearer safe harbor in the regulations that implement the QM, it is unlikely that a broad-based institutional investor market (or indeed any investor market) for mortgages or MBS will develop.

2. Second Liens. Current law allows second liens to be placed on homes without the consent of the first lienor. The thinking behind the provision of the Garn-St Germain Act that permitted this interpretation was probably that the first lienor can always wipe out the second in the event of a default. However, the foreclosure process is very lengthy in many states, and the second lienor can only be wiped out in a foreclosure. Moreover, the second lienor has a right to consent to a modification or a short sale that might be used in lieu of foreclosure. This gives the second lienor considerable leverage for compensation from the holder of the first lien, and of course increases the potential loss on the mortgage.

In addition, the holders of second liens frequently turn out to be the servicers on mortgages in MBS pools, and they sometimes delay or refuse foreclosure. The Garrett bill has a provision on servicer conflicts of interest that should solve this problem, but would not cure the problem of the second lienor refusing to consent to modification or a short sale without some consideration.

Accordingly, the law should be amended to require the approval of the first lienor before a subsequent second lien can be put on the property. Although this might make second mortgages difficult to get, if there is sufficient equity in the home so that a second lien is feasible, the borrower can always do a cash-out refinance, and thus the holder of the first lien has the option to accept the second or see the loan refinanced away. Alternatively, the approval of the first lienor can be limited by providing that there is no approval right if, after the second has been put on, the LTV is no higher than it was when the first lien attached. In this way, the first lienor gets the rights it originally bargained for.

3. **Elimination of other servicer-investor conflicts of interest.** The standardized forms of securitization of documentation should provide for mandatory arbitration of disputes between investors and issuers, and the appointment of a special trustee for investors where there is a conflict of interest between the investors and the servicer.

4. **Disclosure to investors**. There has been substantial variation in the quality of loan-level disclosure to investors about the quality of the mortgages in a pool. The FHFA and the SEC should agree on the disclosures that should be made by issuers in order to increase the transparency and information available to investors.

5. **Pricing disclosure**. The FHFA and the SEC should develop ways to increase the disclosure to the market of pricing information.

IV. Comments on the Garrett Bill

This section is divided into three parts—those provisions where the Garrett bill advances the goal of creating a private securitization market, where it falls short of this goal, and where it creates more impediments and disincentives that impair the achievement of the legislation's intent.

Where Garrett Bill Advances the goal of creating a private securitization market

The Garrett bill contains a number of provisions that address the issues outlined in sections I-III above.

1. **Risk-retention**. The bill repeals the 5% risk-retention provisions of the DFA. These are ineffective in any event, and create substantial impediments for firms that would like to engage in securitization.

2. **Standard classifications of prime loans.** The bill provides for the creation of several standard classifications of what are called "prime mortgages." However, it provides that some mortgage classifications could have "substantial credit risk." It is not clear how a prime mortgage can have substantial credit risk, and thus the language provides a basis for a serious future deterioration in underwriting standards. As a housing bubble develops, it suppresses defaults and delinquencies, so poor quality mortgages look less risky. In addition, as housing prices rise in a bubble, borrowers look for riskier mortgages in order to buy bigger houses with the same or lower monthly payments, and lenders are willing to make these loans because their inherent riskiness is obscured by the effects of the bubble. Exactly this happened in the period leading up to the 2008 financial crisis. If this bill is to reduce the chances of another housing bubble, in addition to encouraging the development of a private securitization market, it is necessary to assure that the mortgages created in the future are truly prime mortgages, and not mortgages "with substantial credit risks." At this point, the legislation does not accomplish this.

It is problematic to direct FHFA to establish categories of risk without specifying how they are supposed to do this. If they look at the last five years, those categories would look very different from what they would look like if they used the credit history of the last 25 years. The legislation should take account of the possibility that FHFA may not be as conservative as they should be when establishing what is a credit risk and what is not.

In this connection, it would be better to specify the minimum terms of a prime mortgage by statute, so that a future regulator cannot easily redefine the term. In 1990, before the affordable housing goals were established for Fannie and Freddie, a 20 percent downpayment was usual for a home and the rate of home ownership was still a robust 64%. The fact that the realtors want to sell more homes, and the homebuilders want to build bigger homes, should not affect what is a prime mortgage. With mortgage insurance, and coverage down to 60 LTV, it should be possible to offer a prime mortgage with 10 percent as a down payment. Leaving FHFA to establish rules for the future could be a serious mistake if the agency—under different leadership—decides to stimulate home ownership by reducing underwriting standards.

In addition, the bill does not instruct the FHFA to limit the number of different classifications so that the liquidity of a future private market is not so severely divided among classifications that the liquidity necessary for a TBA market is not impaired. A TBA market works if there is sufficient liquidity for a mortgage originator to hedge its risk by buying or selling mortgages before a pool has been developed. The current system works because the pools, overall, are very much alike in such qualities as prepayment rates. If there are many different classes of prime mortgages in the future, it may make it difficult to create homogeneous pools.

Finally, the legislation does not say that the standard mortgages it would create are the only mortgages that can be securitized, and that mortgages outside these standards can still be made, but cannot be securitized. That is essential to preserve a free market in mortgages while still protecting the securitization market against the kind of mortgage quality deterioration that occurred before the 2008 financial crisis. In other words, banks and other investors should be able to buy whole loans or portfolios of whole loans that are outside the standard classifications, but those mortgages may not be securitized. This could be rectified by stating that only "qualified securities" under sec 101(b) (4) can be securitized.

3. Standardization of securitization documentation. The bill authorizes the FHFA to create standardized securitization agreements and standardized requirements for trustees and for servicers. It also provides for mandatory arbitration of disputes among investors, servicers and securitization sponsors. However, it isn't clear why the sec 101(b)(2) limits the content of a standardized agreement to only the listed items. A different view of the provisions covered sponsors are outlined below.

4. Improvement in the QM provisions. By providing that the QM provisions in the DFA do not apply to a "qualified security" as defined in the bill, the legislation goes some distance toward eliminating the most troublesome element of the QM provisions in the DFA—the defense to foreclosure provision. Nevertheless, there are still ambiguities in the Truth In Lending Act (TILA) which could mean that a borrower will be able to defend against foreclosure by alleging a violation of one of the remaining exemptions from TILA. This should be remedied. The possibility that there might be nonmonetary defenses to foreclosure will make mortgage lending very risky in the future. Unless these TILA exemption ambiguities can be cleared away, the defense to foreclosure provisions in the DFA should be repealed.

5. **Exemption from registration.** By providing an exemption from registration under the Securities Act of 1933, as amended, the bill substantially eases and reduces the costs of the securitization process and hedging in the TBA market.

Where the Garrett Bill does not go far enough to achieve its goal

1. **Wind-down of Fannie and Freddie.** For the reasons outline above, the Garrett bill will not be effective in opening a market for private securitization if it does not eventually contain provisions which call for the gradual wind-down of the GSEs Fannie Mae and Freddie Mac through a reduction in their conforming loan limits.

2. **FDIC safe harbor.** Banks will find it very difficult to resume a role as securitizers as long as the FDIC's safe harbor continues to exist in its current form. The regulation is already in effect, so sec 102 (c) doesn't cover it. The bill should provide that if a pool of mortgages meets the standards as a prime mortgage and is securitized in conformity with the Garrett bill's provisions—i.e., as a qualified security—it will fall within the FDIC's safe harbor regulation.

3. **SEC Regulation AB.** Similarly, the bill should state that as long as a securitization complies with the provisions of the Garrett bill as a qualified security it will not be subject to rescission under Regulation AB.

4. **Premium cash recapture.** The proposed regulations on premium cash recapture, as outlined above, impose substantial costs on securitizers, especially those that do not have large balance sheets (to hold the recaptured cash over an extended period) or profit from the spread on mortgages they originate. Qualified securities under the Garrett bill should be exempt from the premium cash recapture provisions of the DFA.

5. **Volcker Rule.** It's already clear that the regulations under the Volcker rule will be so complicated that many securitizers will not be able to determine the conditions under which they can hedge their risks by buying or selling mortgages before their securitized pools are complete. The Garrett bill should provide that the Volcker rule applies only to insured banks, and not to "banking related entities." That will enable the affiliates of banks to hedge their risks in securitizations.

6. **Second liens.** Under current law, second liens can be added to home mortgages more or less at the will of borrowers, and without notice to the first lienor. Yet second liens create additional risks for the first lien that were not taken into account when that was negotiated. In commercial mortgages, second liens are not allowed without the consent of the first lienor on property. The Garrett bill should provide that second liens cannot be added to a home without the approval of the holder of the first lien, or that the first lienor's right of approval is ineffective if the LTV on the mortgage is no higher than it was when the first lien was negotiated.

Where the Garrett bill creates impediments to the development of a private market

1. **Standards for qualified sponsors.** One of the benefits of securitization is that it is open to anyone. The quality of a securitization does not depend on the wherewithal of the securitizer, but rather on the mortgages in the pool and the amount of subordination . The Garrett bill contains unnecessary provisions for the registration of securitization sponsors with the FHFA. These will provide opportunities for costly bureaucratic rules and regulations that serve no useful purpose but will add to the costs of securitization and narrow the competitive field. This provision should be eliminated from the bill.

2. **Disclosure of information.** It is important to understand that TBA market achieves liquidity because of a convention that all pools will have approximately the same makeup and characteristics. Disclosure is generally a good idea, but it could interfere with the development of a TBA market. The same is true for loan level information in Title II. These provisions should be carefully vetted by the Securities Industry and Financial Markets Association, which has developed the convention on what information about pools should made available in order to foster a TBA market.

Mr. Chairman and members of the committee, that completes my testimony.

NATIONAL
COMMUNITY
REINVESTMENT
COALITION

NCRC

727 15th Street, NW Suite 900
Washington, DC 20005-6027
Phone: 202 628-8866
Fax: 202 628-9800
Website: www.ncrc.org

October 31, 2011

The Honorable Norm Dicks, Ranking Member
House Committee on Appropriations
2467 Rayburn House Office Building
Washington, DC 20515

By Fax to 202-226-1176

Dear Congressman Dicks,

As the House of Representatives is set to consider an extension of high cost area loan limits for the Federal Housing Administration (FHA), Fannie Mae and Freddie Mac (the GSEs), I urge you to say no to higher loan limits. This measure has already passed in the U.S. Senate and will channel more loans from higher-income borrowers away from conventional lending and into the FHA single-family fund. This will occur at precisely the time when the FHA should be targeting low- and moderate income borrowers, to both help keep existing homeowners in their homes and to provide first-time borrowers with affordable mortgage alternatives.

Under the new proposal, high cost area loan limits would be raised from the current maximum of $625,500 back to $729,750. However, to afford an FHA-insured mortgage of $729,750, a borrower would need an annual income of over $185,000 – even as mortgage interest rates are at all-time lows. To afford a $625,500 mortgage, a borrower still would need an income of over $155,000. To put these income numbers into context, recently released Congressional Budget Office (CBO) data has shown that the proposed high cost area loan limits would only benefit the top 5 percent of US households.[1] CBO also indicates that growth in income for the top income earners vastly exceeds growth of all households. Why is Congress moving the FHA program to serve borrowers at a higher income level, especially now when we know that the share of income going to high-income earners has grown and the share of income to low- and moderate income families has actually declined?[2]

It might be argued that the GSE limits should be available to these very high-income borrowers in order to keep a liquid secondary market. But who are the GSE borrowers, other than high-income borrowers? The GSEs purchase loans primarily from borrowers making large down payments – the Federal Housing Finance Agency's annual report to Congress reported that the average downpayment for a GSE purchased loan in 2010 was over 30 percent. But FHA is very different, the average down payment for the FHA borrower in 2010 was less than five percent. Moreover, FHA's historical intent was to serve only moderate-income borrowers with low down payments.

NATIONAL
COMMUNITY
REINVESTMENT
COALITION
NCRC

Keeping both FHA and the GSEs at very high loan limits would be bad enough, but the current proposal goes beyond equal treatment for FHA and the GSEs. It actually mandates that the GSEs charge special fees that inevitably will direct more high-income, low down payment borrowers to FHA and away from conventional mortgages. Under the Senate measure, the GSEs are required to charge an extra 15 basis points for all loans over $625,500, which is passed on to the borrower in the form of a higher cost mortgage. The FHA is not required to charge an extra fee. As a result, lenders and low-down payment borrowers will inevitably choose the lowest cost option. That option will be FHA.

If FHA were financially sound, this proposal would simply be bad policy as more low down payment, high-income borrowers are directed to FHA and its 100 percent taxpayer guarantee. However, FHA is on thin ice financially. The FHA actuarial fund is required by Congress to have a 2 percent capital ratio. For the past two years, FHA has had only a bare 0.5 percent capital level. Diverting more high-income, low-down payment borrowers to FHA means that additional financial burden will be placed unnecessarily on the FHA fund and on the taxpayer at a time when the financial resources of the single family fund need to be husbanded to benefit moderate income borrowers.

Finally, President Obama and the Congress have made clear their intention to reduce FHA's market share by 50%, further reducing the role that they play in the mortgage market. By raising the loan limits, prospective working-class homeowners will find the bar raised even higher as they compete with higher income households for the increasingly scarce mortgage guarantees offered by FHA.

Let the market serve those of greater means; say no to the higher loan limits.

Sincerely yours,

John Taylor
President & CEO

[1] Trends in the Distribution of Household Income 1979 to 2007, October 2011, see Appendix A page 35 at http://www.cbo.gov/ftpdocs/124xx/doc12485/10-25-HouseholdIncome.pdf, finding that household income in excess of $137,000 in 2007 set the floor for the top 5% of households.

[2] Ibid., p.1 summary.

NATIONAL
COMMUNITY
REINVESTMENT
COALITION
NCRC

727 15th Street, NW Suite 900
Washington, DC 20005-6027
Phone: 202 628-8866
Fax: 202 628-9800
Website: www.ncrc.org

October 31, 2011

The Honorable John Olver, Ranking Member
Subcommittee on Transportation, Housing and Urban Development
1111 Longworth House Office Building
Washington, DC 20515

By Fax to 202-226-1224

Dear Congressman Dicks,

As the House of Representatives is set to consider an extension of high cost area loan limits for the Federal Housing Administration (FHA), Fannie Mae and Freddie Mac (the GSEs), I urge you to say no to higher loan limits. This measure has already passed in the U.S. Senate and will channel more loans from higher-income borrowers away from conventional lending and into the FHA single-family fund. This will occur at precisely the time when the FHA should be targeting low- and moderate income borrowers, to both help keep existing homeowners in their homes and to provide first-time borrowers with affordable mortgage alternatives.

Under the new proposal, high cost area loan limits would be raised from the current maximum of $625,500 back to $729,750. However, to afford an FHA-insured mortgage of $729,750, a borrower would need an annual income of over $185,000 – even as mortgage interest rates are at all-time lows. To afford a $625,500 mortgage, a borrower still would need an income of over $155,000. To put these income numbers into context, recently released Congressional Budget Office (CBO) data has shown that the proposed high cost area loan limits would only benefit the top 5 percent of US households.[1] CBO also indicates that growth in income for the top income earners vastly exceeds growth of all households. Why is Congress moving the FHA program to serve borrowers at a higher income level, especially now when we know that the share of income going to high-income earners has grown and the share of income to low- and moderate income families has actually declined?[2]

It might be argued that the GSE limits should be available to these very high-income borrowers in order to keep a liquid secondary market. But who are the GSE borrowers, other than high-income borrowers? The GSEs purchase loans primarily from borrowers making large down payments – the Federal Housing Finance Agency's annual report to Congress reported that the average downpayment for a GSE purchased loan in 2010 was over 30 percent. But FHA is very different, the average down payment for the FHA borrower in 2010 was less than five percent. Moreover, FHA's historical intent was to serve only moderate-income borrowers with low down payments.

NATIONAL
COMMUNITY
REINVESTMENT
COALITION
NCRC

Keeping both FHA and the GSEs at very high loan limits would be bad enough, but the current proposal goes beyond equal treatment for FHA and the GSEs. It actually mandates that the GSEs charge special fees that inevitably will direct more high-income, low down payment borrowers to FHA and away from conventional mortgages. Under the Senate measure, the GSEs are required to charge an extra 15 basis points for all loans over $625,500, which is passed on to the borrower in the form of a higher cost mortgage. The FHA is not required to charge an extra fee. As a result, lenders and low-down payment borrowers will inevitably choose the lowest cost option. That option will be FHA.

If FHA were financially sound, this proposal would simply be bad policy as more low down payment, high-income borrowers are directed to FHA and its 100 percent taxpayer guarantee. However, FHA is on thin ice financially. The FHA actuarial fund is required by Congress to have a 2 percent capital ratio. For the past two years, FHA has had only a bare 0.5 percent capital level. Diverting more high-income, low-down payment borrowers to FHA means that additional financial burden will be placed unnecessarily on the FHA fund and on the taxpayer at a time when the financial resources of the single family fund need to be husbanded to benefit moderate income borrowers.

Finally, President Obama and the Congress have made clear their intention to reduce FHA's market share by 50%, further reducing the role that they play in the mortgage market. By raising the loan limits, prospective working-class homeowners will find the bar raised even higher as they compete with higher income households for the increasingly scarce mortgage guarantees offered by FHA.

Let the market serve those of greater means; say no to the higher loan limits.

Sincerely yours,

John Taylor
President & CEO

---

[1] Trends in the Distribution of Household Income 1979 to 2007, October 2011, see Appendix A page 35 at http://www.cbo.gov/ftpdocs/124xx/doc12485/10-25-HouseholdIncome.pdf, finding that household income in excess of $137,000 in 2007 set the floor for the top 5% of households.

[2] Ibid., p.1 summary.

NATIONAL COMMUNITY REINVESTMENT COALITION

NCRC

727 15th Street, NW Suite 900
Washington, DC 20005-6027
Phone: 202 628-8866
Fax: 202 628-9800
Website: www.ncrc.org

October 31, 2011

The Honorable Hal Rogers, Chairman
House Committee on Appropriations
2406 Rayburn House Office Building
Washington, DC 20515

By Fax to 202-225-0940

Dear Congressman Rogers,

As the House of Representatives is set to consider an extension of high cost area loan limits for the Federal Housing Administration (FHA), Fannie Mae and Freddie Mac (the GSEs), I urge you to say no to higher loan limits. This measure has already passed in the U.S. Senate and will channel more loans from higher-income borrowers away from conventional lending and into the FHA single-family fund. This will occur at precisely the time when the FHA should be targeting low- and moderate income borrowers, to both help keep existing homeowners in their homes and to provide first-time borrowers with affordable mortgage alternatives.

Under the new proposal, high cost area loan limits would be raised from the current maximum of $625,500 back to $729,750. However, to afford an FHA-insured mortgage of $729,750, a borrower would need an annual income of over $185,000 -- even as mortgage interest rates are at all-time lows. To afford a $625,500 mortgage, a borrower still would need an income of over $155,000. To put these income numbers into context, recently released Congressional Budget Office (CBO) data has shown that the proposed high cost area loan limits would only benefit the top 5 percent of US households.[1] CBO also indicates that growth in income for the top income earners vastly exceeds growth of all households. Why is Congress moving the FHA program to serve borrowers at a higher income level, especially now when we know that the share of income going to high-income earners has grown and the share of income to low- and moderate income families has actually declined?[2]

It might be argued that the GSE limits should be available to these very high-income borrowers in order to keep a liquid secondary market. But who are the GSE borrowers, other than high-income borrowers? The GSEs purchase loans primarily from borrowers making large down payments – the Federal Housing Finance Agency's annual report to Congress reported that the average downpayment for a GSE purchased loan in 2010 was over 30 percent. But FHA is very different, the average down payment for the FHA borrower in 2010 was less than five percent. Moreover, FHA's historical intent was to serve only moderate-income borrowers with low down payments.

NATIONAL COMMUNITY REINVESTMENT COALITION NCRC

Keeping both FHA and the GSEs at very high loan limits would be bad enough, but the current proposal goes beyond equal treatment for FHA and the GSEs. It actually mandates that the GSEs charge special fees that inevitably will direct more high-income, low down payment borrowers to FHA and away from conventional mortgages. Under the Senate measure, the GSEs are required to charge an extra 15 basis points for all loans over $625,500, which is passed on to the borrower in the form of a higher cost mortgage. The FHA is not required to charge an extra fee. As a result, lenders and low-down payment borrowers will inevitably choose the lowest cost option. That option will be FHA.

If FHA were financially sound, this proposal would simply be bad policy as more low down payment, high-income borrowers are directed to FHA and its 100 percent taxpayer guarantee. However, FHA is on thin ice financially. The FHA actuarial fund is required by Congress to have a 2 percent capital ratio. For the past two years, FHA has had only a bare 0.5 percent capital level. Diverting more high-income, low-down payment borrowers to FHA means that additional financial burden will be placed unnecessarily on the FHA fund and on the taxpayer at a time when the financial resources of the single family fund need to be husbanded to benefit moderate income borrowers.

Finally, President Obama and the Congress have made clear their intention to reduce FHA's market share by 50%, further reducing the role that they play in the mortgage market. By raising the loan limits, prospective working-class homeowners will find the bar raised even higher as they compete with higher income households for the increasingly scarce mortgage guarantees offered by FHA.

Let the market serve those of greater means; say no to the higher loan limits.

Sincerely yours,

John Taylor
President & CEO

[1] Trends in the Distribution of Household Income 1979 to 2007, October 2011, see Appendix A page 35 at http://www.cbo.gov/ftpdocs/124xx/doc12485/10-25-HouseholdIncome.pdf, finding that household income in excess of $137,000 in 2007 set the floor for the top 5% of households.

[2] Ibid., p.1 summary.

NATIONAL
COMMUNITY
REINVESTMENT
COALITION
NCRC

727 15th Street, NW Suite 900
Washington, DC 20005-6027
Phone: 202 628-8866
Fax: 202 628-9800
Website: www.ncrc.org

October 31, 2011

The Honorable Tom Latham, Chairman
Subcommittee on Transportation, Housing and Urban Development
2217 Rayburn House Office Building
Washington, DC 20515

By Fax to 202-225-3301

Dear Congressman Latham,

As the House of Representatives is set to consider an extension of high cost area loan limits for the Federal Housing Administration (FHA), Fannie Mae and Freddie Mac (the GSEs), I urge you to say no to higher loan limits. This measure has already passed in the U.S. Senate and will channel more loans from higher-income borrowers away from conventional lending and into the FHA single-family fund. This will occur at precisely the time when the FHA should be targeting low- and moderate income borrowers, to both help keep existing homeowners in their homes and to provide first-time borrowers with affordable mortgage alternatives.

Under the new proposal, high cost area loan limits would be raised from the current maximum of $625,500 back to $729,750. However, to afford an FHA-insured mortgage of $729,750, a borrower would need an annual income of over $185,000 – even as mortgage interest rates are at all-time lows. To afford a $625,500 mortgage, a borrower still would need an income of over $155,000. To put these income numbers into context, recently released Congressional Budget Office (CBO) data has shown that the proposed high cost area loan limits would only benefit the top 5 percent of US households.[1] CBO also indicates that growth in income for the top income earners vastly exceeds growth of all households. Why is Congress moving the FHA program to serve borrowers at a higher income level, especially now when we know that the share of income going to high-income earners has grown and the share of income to low- and moderate income families has actually declined?[2]

It might be argued that the GSE limits should be available to these very high-income borrowers in order to keep a liquid secondary market. But who are the GSE borrowers, other than high-income borrowers? The GSEs purchase loans primarily from borrowers making large down payments – the Federal Housing Finance Agency's annual report to Congress reported that the average downpayment for a GSE purchased loan in 2010 was over 30 percent. But FHA is very different, the average down payment for the FHA borrower in 2010 was less than five percent. Moreover, FHA's historical intent was to serve only moderate-income borrowers with low down payments.

NATIONAL
COMMUNITY
REINVESTMENT
COALITION
NCRC

Keeping both FHA and the GSEs at very high loan limits would be bad enough, but the current proposal goes beyond equal treatment for FHA and the GSEs. It actually mandates that the GSEs charge special fees that inevitably will direct more high-income, low down payment borrowers to FHA and away from conventional mortgages. Under the Senate measure, the GSEs are required to charge an extra 15 basis points for all loans over $625,500, which is passed on to the borrower in the form of a higher cost mortgage. The FHA is not required to charge an extra fee. As a result, lenders and low-down payment borrowers will inevitably choose the lowest cost option. That option will be FHA.

If FHA were financially sound, this proposal would simply be bad policy as more low down payment, high-income borrowers are directed to FHA and its 100 percent taxpayer guarantee. However, FHA is on thin ice financially. The FHA actuarial fund is required by Congress to have a 2 percent capital ratio. For the past two years, FHA has had only a bare 0.5 percent capital level. Diverting more high-income, low-down payment borrowers to FHA means that additional financial burden will be placed unnecessarily on the FHA fund and on the taxpayer at a time when the financial resources of the single family fund need to be husbanded to benefit moderate income borrowers.

Finally, President Obama and the Congress have made clear their intention to reduce FHA's market share by 50%, further reducing the role that they play in the mortgage market. By raising the loan limits, prospective working-class homeowners will find the bar raised even higher as they compete with higher income households for the increasingly scarce mortgage guarantees offered by FHA.

Let the market serve those of greater means; say no to the higher loan limits.

Sincerely yours,

John Taylor
President & CEO

---

[1] Trends in the Distribution of Household Income 1979 to 2007, October 2011, see Appendix A page 35 at http://www.cbo.gov/ftpdocs/124xx/doc12485/10-25-HouseholdIncome.pdf, finding that household income in excess of $137,000 in 2007 set the floor for the top 5% of households.

[2] Ibid., p.1 summary.

National Association of Home Builders

1201 15th Street NW
Washington, DC 20005

T 800 368 5242
F 202 266 8400

www.nahb.org

NAHB

Government Affairs

James W. Tobin III
Senior Vice President & Chief Lobbyist

November 2, 2011

The Honorable Scott Garrett
Chairman
Capital Markets and Government Sponsored
Enterprises Subcomittee
United States House of Representatvives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
Capital Markets and Government Sponsored
Enterprises Subcomittee
United States House of Representatvives
Washington, DC 20515

Dear Chairman and Ranking Member:

On behalf of the 160,000 members of the National Association of Home Builders (NAHB), I am writing to express NAHB's thoughts on the Discussion Draft of the *Private Mortgage Market Investment Act* that will be the focus of Thursday's hearing before the Subcommittee on Capital Markets and Government Sponsored Enterprises.

Legislation to encourage and strengthen the return of private investment in the market should be pursued; however NAHB believes that a federal backstop must be preserved, as part of a comprehensive reform effort, to ensure a reliable and adequate flow of affordable housing credit without potential geographic restraints and in all economic and financial conditions. While NAHB supports the objective of the draft bill to facilitate a strong and robust private sector securitization market, and we look forward to contributing thoughtful recommendations to enhance the draft bill's provisions, we remain concerned that the aim of the larger legislative effort currently underway is to dismantle all government backing of the nation's mortgage market.

NAHB has testified before the subcommittee outlining our ideas for developing a safe and sound housing finance structure. However, we believe that changes to the housing finance system should be comprehensive, coordinated and undertaken in a careful and deliberate manner that does not disrupt the nascent housing recovery. Furthermore, NAHB insists that a continuing and predictable government role is necessary to promote investor confidence and ensure liquidity and stability for homeownership and rental housing. While private capital must be the dominant source of mortgage credit, the future housing finance system cannot be left entirely to the private sector. The historical track record clearly shows that the private sector is not capable of providing a consistent and adequate supply of housing credit without a government backstop.

Again, NAHB looks forward to working with the subcommittee to strengthen and improve the draft legislation, but remains concerned that the larger reform effort currently underway would remove all federal support of the nation's mortgage market.

Thank you for giving consideration to our views.

Sincerely,

James W. Tobin III

Cc: Rep. Spencer Bachus, Chairman, House Financial Services Committee; Rep. Barney Frank, Ranking Member, House Financial Services Committee

FEDERAL HOUSING FINANCE AGENCY
Office of the Director

January 11, 2012

The Honorable Lynn Westmoreland
U.S. House of Representatives
2433 Rayburn House Office Building
Washington, DC 20515

Dear Representative Westmoreland:

In response to the questions for the record that you submitted for the November 3, 2011, Capital Markets and Government Sponsored Enterprises Subcommittee hearing, I am providing the following information. Your questions and the Federal Housing Finance Agency (FHFA) responses are provided here.

Question 1. FHFA is directing the GSEs to transition away from requiring servicers to use the GSEs' Foreclosure Attorney Networks. As I understand it, the GSEs' relationships with the firms in these networks were not the result of a federal procurement process or an analogous process with clear guidelines and objectively-applied criteria. Instead, these relationships were based on "relationship-marketing," where the contracts were given to those firms who did the best job of courting the GSEs. As a result, these networks fostered exclusive relationships between the GSEs and a few select law firms in each state and unfairly eliminated competition from other firms. Can you describe Fannie Mae's and Freddie Mac's existing processes and procedures for selecting law firms, including the existing quality control and auditing mechanisms that are in place?

Response. FHFA conducted special reviews of Fannie Mae's Retained Attorney Network and Freddie Mac's Designated Counsel Program and identified weaknesses in policies and procedures, training programs, and performance measures for participating law firms. The lawyers designated were engaged by servicers and their performance was the primary responsibility of the servicers. FHFA issued directives requiring the Enterprises to phase out their existing attorney networks and to, among other things, adopt uniform standards for managing default- and foreclosure-related legal services. In fulfillment of these directives, the Enterprises must improve their quality control, internal audit, and counterparty risk management practices.

FHFA's efforts supplement and complement consent order requirements imposed on large mortgage servicers by the Federal banking regulators last year. The consent orders require, among other things, the development of policies and procedures for evaluating, retaining, overseeing, and measuring the performance of law firms that provide default- and foreclosure-related legal services. Mortgage servicers have had, and will continue to have, direct responsibility for overseeing the law firms that provide these services.

The Enterprises do not follow federal procurement processes in selecting law firms. Rather, they follow their own contracting procedures, which are designed to be fair and objective. To date, Freddie Mac has conducted research on qualified law firms in individual markets, then solicited the law firms individually, inviting them to apply. Fannie Mae followed a different approach, periodically publishing requests for proposal on its website and evaluating the submissions received.

For both Enterprises, interested firms are evaluated based on their ability to provide a variety of foreclosure and foreclosure-related legal services, including foreclosure, bankruptcy, REO, evictions, foreclosure avoidance, and litigation. The Enterprises also consider other factors such as diversity, technology, capacity, case reporting, past disciplinary actions, and privacy policies. Internal groups within the Enterprises evaluate each applicant's information and the Enterprises select firms based on each firm's overall qualifications. FHFA has not found evidence that the Enterprises selected law firms on the basis of "relationship-marketing."

With regard to existing quality control and auditing mechanisms, the Enterprises exercise oversight over participating firms primarily through a combination of performance metrics and reviews of firm practices conducted by in-house personnel and third parties. The general objective is to ensure that firms handle cases expeditiously and cost-effectively if there is no viable alternative to the borrower other than foreclosure. Given this objective, performance metrics include adherence to contractual fee schedules and prescribed foreclosure timelines. In addition, the Enterprises review the fees charged by firms to identify fees that exceed authorized amounts. Oversight of firm practices also includes sampling of aged cases to assess law firm performance. As noted earlier, mortgage servicers are also responsible for overseeing law firms to ensure that they adhere to servicing requirements established by Fannie Mae and Freddie Mac.

Question 2. As I understand it, the GSEs fixed the fees that network firms could charge for default-related services and insisted that firms complete foreclosure cases within ever-decreasing time frames. Combining those two factors with the GSEs' over-reliance on a few select law firms in each state without regard to the existence of adequate safety and soundness oversight, adequate infrastructure, or adequate capital, as foreclosures volumes grew during the housing crisis, weren't the network firms incentivized to develop practices, like "robo-signing", to rapidly process large volumes of cases rather than focusing on the quality of legal services?

Response. FHFA, the Enterprises, borrowers, and taxpayers share an interest in ensuring that foreclosure-related legal services are high quality, timely, and cost-effective. Fee schedules protect against inordinately high legal costs, and prescribed timelines provide a useful, though not exclusive, measure of attorney performance and efficiency. FHFA believes that the appropriate combination of fee schedules and performance timelines, together with appropriate qualitative standards for the law firms' performance, will further the interests of all stakeholders

It is important to note that foreclosure timelines are a function of the specific requirements mandated by state and local laws and rules, including requirements established by individual judges and court systems. Those requirements have changed substantially over the course of the last several years, and, generally, foreclosure timelines have gotten longer. FHFA works with the Enterprises to ensure that timelines set forth in the Enterprises' guidance materials reflect jurisdictional requirements and provide attorneys with sufficient time to manage their cases.

FHFA agrees that "robo-signing" and improper conduct in the foreclosure process must be eliminated and emphasizes that any network law firm that engages in conduct that does not comport with applicable legal and professional standards is not in compliance with the terms of contractual agreements with the Enterprises. These agreements expressly require firms to adhere to all applicable laws, rules, and professional standards. FHFA nevertheless believes the Enterprises' current processes can be improved to better assure that network law firms do not engage in unethical or improper practices and has issued directives to the Enterprises in this regard.

Question 3. If the FHFA does, in fact, take up true reform of its foreclosure attorney selection process, FHFA has a real opportunity to promote transparency in its vendor selection process and improve the quality of legal services in this area. However, the FHFA's press release announcing that the agency has directed the GSEs to adopt uniform improvements to these networks omits key details including: the specific ways in which you plan to reform your foreclosure attorney selection process; when you will implement those plans; and the process by which you will consult with all market participants as you develop these plans, including third-party service providers. What are your concrete plans for reforming these networks? How soon will you implement them? What is your plan for gathering input from all market participants?

Response. FHFA has issued directives to the Enterprises that require the Enterprises to phase out their attorney networks and work with FHFA to develop a new structure for managing their default- and foreclosure-related legal services under FHFA's Servicing Alignment Initiative. FHFA is working diligently with the Enterprises, banking regulators, and with market participants that have responded to the press release to implement the directives. In general, the FHFA directives contemplate a transitional period during which the Enterprises incorporate uniform law firm eligibility criteria into their Servicing Guides, and provide guidance to mortgage loan servicers regarding default- and foreclosure-related legal services. The guidance will cover a number of important topics, including law firm oversight, monitoring, reporting, communications, and metrics for mortgage servicers and for legal counsel providing foreclosure-related services.

This is a complex undertaking that deserves careful deliberation and coordination in order to avoid undue industry disruption. FHFA believes that these efforts will serve the long-term interests of the mortgage finance industry by facilitating the coordinated development of transparent standards and will benefit borrowers that become subject to the foreclosure process. Moreover, these efforts are consistent with actions taken by the Federal banking regulators and consent order provisions that focus on third party providers, including law firms providing default- and foreclosure-related legal services. FHFA is not in a position to identify a final implementation date, however, the agency expects that uniform law firm qualifications criteria will be developed during the first quarter of 2012.

If you have further questions, please do not hesitate to contact Peter Brereton, Associate Director for Congressional Affairs, on my staff at (202) 414-3799.

Sincerely,

Edward J. DeMarco

Edward J. DeMarco
Acting Director

xc: The Honorable Scott Garrett