Statement of:

Tom Deutsch
Executive Director
American Securitization Forum

Testimony before the:

Committee on Financial Services
United States House of Representatives

Hearing on:

The Future of Housing Finance—
A Review of Proposals to Address Market Structure and Transition

September 29, 2010

One World Financial Center, 30th Floor ▪ New York, NY 10281 ▪ 212.412.7100 ▪ www.americansecuritization.com

Chairman Frank, Ranking Member Bachus and distinguished Members of the Committee, 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 on behalf of the 330 ASF member institutions who originate, structure and invest in 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").

In this testimony, I seek to address these key issues to the future of US housing finance:

1. Importance of the Process of Securitization to Mortgage Lending
2. Transitional Concerns Related to the GSEs
3. Future Structure of Any Government Role in the Secondary Mortgage Market
4. Return of a Private Secondary Mortgage Market
5. Industry Improvements to the Securitization Market Infrastructure
6. Covered Bonds Legislation

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 involvement in housing finance, and to have more private capital eventually replace many of the risks and rewards of that involvement. Given that 89% of mortgage loans made in America in the first half of 2010 were guaranteed by the GSEs, there isn't a shortage of opportunity to achieve this goal. But we are all aware of the fragile state of the US housing market with real estate prices continuing to fall and new home purchases at historic lows, notwithstanding equally historically low mortgage rates for conforming prime borrowers. As such, there is little opportunity for an overnight transition, but a strong need to begin that transition as soon as possible to restore long-term health to the housing and mortgage markets. The market will not stabilize until home buyers and sellers know where the government and public guarantees are going to land and until all of the securitization reforms have been finalized. There is, therefore, a need for well-considered and well-coordinated haste.

Reducing dependence on public guarantees for new mortgage origination necessarily implies that private capital investment in mortgage originations will have to be reinvigorated. 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

[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.

and reinvigorate the housing market. And as regulatory capital levels rise through various policy initiatives such as Basel III and FAS 166/167, the balance sheets of large banks will be further constrained over time from extending additional mortgage credit. Although key legislative initiatives such as covered bonds 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 mortgage and consumer credit.

As this Committee is aware, the private-label RMBS market for new mortgage origination has been dormant since early 2008, save for one transaction completed this spring. As debate moves forward on the elimination or transformation of the GSEs, I would encourage a debate of equivalent strength as to how to reinvigorate the private-label RMBS market without overburdening that market with regulation or regulatory uncertainty. Although the securitization market has been deeply engaged in its own reform efforts and supportive of some appropriate legislative and regulatory changes, there are now a myriad of proposed and enacted regulations that have created an extraordinary burden for the market to understand and comply within a short period of time. While many of these proposals and initiatives have merit in isolation, there does not appear to be robust macroprudential oversight or rationalization of the potential cumulative consequences of all of these changes—harmonization will be key in order to avoid duplicative (or even potentially contrary) standards and regulatory fragmentation. Fragmentation, in turn, risks not only creating uncertainties that could frustrate the return of responsible private securitization activity, it can also create opportunities for regulatory forum shopping.

Importance of the Process of Securitization to Mortgage Lending

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 years, securitization has grown in large measure because of the benefits and value it delivers to transaction participants and to the financial system, including increased efficiency of funding, reduced cost of financing for businesses and credit for consumers, and incremental credit and liquidity creation. 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.[2]

The first collateralized mortgage obligations (the predecessor securities to today's mortgage-backed securities) were issued in June 1983 by Freddie Mac and were rapidly replicated by the private industry as investors recognized the flexible nature of the obligations and demanded increased issuance thereof. Between 1990 and 2006, just before the downturn, RMBS issuance

[2] 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). http://www.americansecuritization.com/uploadedFiles/ASFRegABIICommentLetter8.2.10.pdf.

grew at an annually compounded rate of 13%, from $259 billion to $2 trillion a year.[3] It has been estimated that securitization has funded some 59% of outstanding home mortgages.[4]

Ultimately, the process of securitization links the origination capabilities of lending institutions with the long-term investment needs of pension funds, mutual funds and sovereign wealth funds. Put another way, securitization allows the senior teacher's retirement assets to lend important mortgage credit to the junior policeman. Through an effective process, the teacher earns higher returns on his retirement savings and the policeman pays a lower interest rate on his mortgage.

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.

During this transition though, it is absolutely essential that any arrangements not impair or create uncertainty regarding the guarantees of previously-issued GSE RMBS. Having now largely resolved the uncertainty regarding the explicit versus implicit nature of the guarantees, the ASF feels that it would be an extraordinary error if any transitional arrangements altered previous commitments. Any uncertainties created on past securities would immediately call into question for investors the credibility and value of any future guarantees.

Second, there shouldn't be any underestimation of the critical importance of maintaining the so-called "To-Be-Announced" ("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. For a variety of reasons discussed more fully in the ASF's comment letter submitted this summer to the Departments of Treasury and Housing and Urban Development in response to the April 7, 2010 request of those Departments (the "ASF Comment Letter," which is attached as Exhibit A")[5], it is difficult to replicate a TBA market outside of the GSEs, though not necessarily impossible in the long-term. As these are very technical and detailed matters, I direct your attention to the ASF Comment Letter.

Finally, some ask how the U.S. government could begin to recoup the hundreds of billions of dollars of GSE losses the US taxpayer will have to otherwise absorb. Although it's not clear how much of that value could realistically be recouped, there are certainly steps that can be taken

---

[3] National Economic Research Associates, Inc. (NERA), "Study of the Impact of Securitization on Consumers, Investors, Financial Institutions and the Capital Markets," pg. 16 (June 2009), www.americansecuritization.com/uploadedFiles/ASF_NERA_Report.pdf.

[4] Citigroup, "Does the World Need Securitization?" pg. 10-11 (December 2008), www.americansecuritization.com/uploadedFiles/Citi121208_restart_securitization.pdf.

[5] See also http://www.americansecuritization.com/uploadedFiles/ASFGSEReformCommentLettertoTreasury-7.21.10.pdf.

to seek maximum value of what is left in the GSEs. First, a responsible evaluation of this question must be anchored in the broader context of building a stable and sustainable model for housing finance policy going forward. This means that approaches need to recognize the significant national interest in an orderly transition to such a stable and sustainable model for housing finance, and accordingly policy solutions must be fair to commercial counterparties and other housing finance partners who are necessary to build for this future. Additionally, no serious commentary that I am aware of suggests that the professional staff of the GSEs, the information technology, the physical plant, or the intellectual property employed by the GSEs were forces that pushed the GSEs into conservatorship. Instead, the system of implicit government guarantees and a weakly empowered oversight regulator appear much more likely to be the root causes of their losses. Any transition plan should preserve in various forms the human capital and other assets the GSEs have built up over the years. As much as some commentators desire to raze to the ground the mistakes of the misguided GSE system and start with a completely blank slate, taxpayer value should be maximized by converting aspects of the industrial organization and physical plant of the GSEs into private market functions. There have been many suggestions of how this may be accomplished, but many focus on the similarities to the process that Sallie Mae went through when they were privatized.

Future Structure of Any Government Role in the Secondary Mortgage Market

The conservatorship of the GSEs has clarified, as a practical matter, that the guarantee feature of the GSE's is, for all intents and purposes, an explicit obligation of the United States. The capital markets find that clarification to be meaningful progress to appropriately price the tail risk associated with GSE RMBS, as it has ended the historical, long-running uncertainty regarding the "implied guarantee." Therefore, through all parts of our membership, ASF members have reached the near consensus that, going forward, any form of federal or agency guarantee should be clear and explicit. We further believe that the most efficient execution is to attach any guarantee directly to the securities issued into the capital markets. Loan-level guarantees, which may serve a role for other purposes, are not ideal for capital markets execution because of their operational and legal challenges. Moreover, as a conceptual matter, the role of any guarantee should be a 'catastrophic' or '100-year flood' structure that allows maximum use of private capital to limit the government's potential liability, while providing a tail risk backstop for other unforeseen risks. If there is a place for any form of government guarantee though, it would create an impetus for the U.S. government to determine if it has a role in setting standards/requirements for the underlying collateral for the securities the government is backing. Dodd-Frank explicitly permits the government to define underwriting standards in certain situations, and those standards may well be appropriate for the entity replacing the GSEs.

A separate question is whether any successor entity or entities to Fannie and Freddie should benefit from federal support/guarantees at the entity level, rather than solely at the mortgage-backed security level. As you know, Fannie and Freddie can, and do, issue debentures which are guaranteed to the same extent as their mortgage-backed securities. These debentures, which of course provide Fannie and Freddie with a favorable cost of funds, have been primarily used to finance the GSEs' portfolios, and the portfolios, in turn, have generated a substantial level of controversy. Ultimately, market participants have significant concerns regarding how a public/private hybrid model of corporate governance could be effective.

The continued maintenance of material portions of the GSEs' portfolios is not broadly supported by the ASF membership. Some argue that successor GSEs should maintain a *de minimus* portfolio for liquidity reasons, but ultimately these proposals vary appreciably in their definitions of what a *de minimus* amount would be. Great caution must be exercised in winding down the sizable portfolio of private label RMBS that the GSEs currently own, as any expedited sale of those assets may impair their value and cause significant disruption in the secondary securities market.

Return of a Private Secondary Mortgage Market

There are a number of provisions of the Dodd-Frank Act ("Dodd-Frank") that the ASF has been supportive of and see as positive developments towards re-establishing a non-government securitization market in the United States. Indeed, we note with great pride that many aspects of the substantive provisions of the Act mirror the ASF's own initiatives to help re-establish this market, especially the ASF's "Project RESTART," which facilitates increased transparency, standardization and diligence to foster renewed investor confidence in securitization. However, the ASF believes it is very important to not consider Dodd-Frank in isolation, as the RMBS and consumer ABS market is currently facing a barrage of regulatory initiatives from the Federal Deposit Insurance Corporation (the "FDIC"), the Securities and Exchange Commission (the "SEC"), the banking agencies, and numerous other regulatory bodies, not to mention potential future regulation that may emerge from the Consumer Financial Protection Bureau. It is also important to note that while Dodd-Frank calls for an interagency process to define risk retention and underwriting standards, some regulators such as the FDIC have issued regulations on a unilateral basis, which creates additional challenges.

Over the last year and a half, the securitization market has been confronted with a wave of legislative and regulatory action, including the securitization-related provisions of the Dodd-Frank Act, the FDIC's final rule relating to its securitization legal isolation safe harbor (the "Safe Harbor Rule"), the disclosure rules ("New Regulation AB") proposed by the SEC, changes in regulatory capital requirements, international initiatives such as "Basel III" and changes in generally accepted accounting principles ("GAAP"). While ASF acknowledges that legislators and regulators at many levels have an interest in addressing past securitization problems, our members are concerned about the impact of multiple layers of securitization legislation and regulation, especially when those regulations are implemented on a unilateral basis that are not often well-coordinated. If each interested regulatory body adopts a separate proposal to address concerns with past securitization practices, the fragile securitization markets face the threat of regulatory overload. Legislative and regulatory changes require U.S. financial institutions to make systems changes as well as documentation changes, which can take substantial time and be very costly. Successive waves of regulation will inevitably slow down the restart of the securitization markets. Ultimately, if the aggregate burden for U.S. financial institutions is too great, it could lead them to significantly reduce the amount of their securitization activities or abandon securitization altogether and rely on deposits or other alternative sources of funding.[6] This would likely lead to a contraction of available credit for consumer finance where securitization has historically provided a significant source of funding. Or in the case of private label RMBS, prevent its restart.

The Dodd-Frank Act addresses risk retention, ongoing reporting requirements, due diligence and disclosure requirements, representations and warranties, and conflicts of interest in securitization. There is significant overlap between the legislation and the matters covered by the Safe Harbor Rule promulgated by the FDIC and New Regulation AB proposed by the SEC. The imposition of reforms on a unilateral rather than interagency basis will ultimately lead to multiple requirements for U.S. financial institutions that are securitizers. For instance, there theoretically could be three different retention requirements imposed on U.S. financial institutions: one imposed this past Monday by the FDIC on insured depository institutions as part of the Safe Harbor Rule, a second imposed by the SEC on all financial institutions for shelf eligibility and a third imposed by Congress as part of federal legislation and implementing regulations of Dodd-Frank. Those retention requirements will likely be structured differently and implemented at different points in time. In addition to being confusing and costly to implement, differing rules could be disadvantageous for financial institutions that are subject to the more onerous regulations. For example, if the requirements for securitization by U.S. insured depository institutions are significantly more restrictive than those for other entities engaging in securitizations, those requirements will pose an undue burden for U.S. insured depository institutions. We therefore believe that any regulation of securitization should be implemented on an interagency basis to create not only a level playing field for all financial institutions but also to enable each institution to more effectively determine the aggregate burden associated with such regulations.

Capital relief has long been and continues to be an objective and advantage of securitization. GAAP has generally been used as an initial measure to determine whether an asset is treated as on or off-balance sheet for risk-based capital requirements, which are intended to reflect risks associated with on-balance sheet exposures as well as off-balance sheet exposures. With the implementation of FAS 166/167 and the fundamental transition for securitization accounting to move from a risk-based framework to a control-based framework, the assets of formerly off-balance sheet securitizations were more likely to come back on-balance sheet for accounting purposes and new transactions using the same traditional structures were more likely to be on-balance sheet going forward. Under the new bank regulator rules issued in January, U.S. institutions will be required to maintain risk-based capital as if there had been no risk transfer through securitization on the basis that they have retained too much risk. At the same time, they

[6] A recent *Global Financial Stability Report* issued by the International Monetary Fund states: "While most of the current proposals are unambiguously positive for securitization markets and financial stability, some proposals—such as those designed to improve the alignment of securitizer and investor interests and accounting changes that will result in more securitized assets remaining on balance sheets—may be combined in ways that could halt, not restart, securitization, by inadvertently making it too costly for securitizers." John Kiff, Andy Jobst, Michael Kisser and Jodi Scarlata, Chapter 2, *Restarting Securitization Markets: Policy Proposals and Pitfalls*, (October 10, 2009) at 77, available at www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/chap2.pdf.

would be required under various regulations to retain 5% of the credit risk of the transferred assets to assure a sufficient exposure to risk to encourage improved underwriting of loans. We are concerned about reforms that impose significant costs on U.S. institutions yet are justified by seemingly contradictory rationales.

Additionally, the retention of a material portion of the credit risk of the financial assets in a securitization could also cause the assets of a securitization that would otherwise be off-balance sheet to be brought back on-balance sheet for accounting purposes. If the minimum 5% interest retained by a financial institution is viewed as a significant economic interest in a variable interest entity under FAS 167 and the financial institution is also the servicer or is viewed as having the power to direct the activities of the securitization vehicle that significantly impact the securitization vehicle's economic performance, then such an interest could cause the consolidation of the securitization entity's assets onto the balance sheet of the financial institution and triggers substantially more capital required to be held.

The timing of regulations will also be critical. As an example, the new securitization safe harbor takes effect on January 1, 2011, which will likely be prior to the enactment of a final version of New Regulation AB or any of the regulations outlined in Dodd-Frank. This means that U.S. insured depository institutions will have to make significant documentation and systems changes in order to avail themselves of the benefits of the securitization safe harbor, without even knowing whether other rules enacted by the SEC or other regulators will be consistent. For instance, the safe harbor rule requires disclosure of loan-level data for RMBS securitizations without specifically identifying all data to be disclosed. New Regulation AB also proposes the requirement that loan-level data for RMBS securitizations and identifies specific fields of information that should be disclosed. The SEC has received substantial comments on these loan-level disclosures and may make significant changes to those requirements in a final set of rules. Issuers will need to assess whether to incur high costs and divert significant personnel and technological resources to make the fundamental changes required to comply with the disclosure requirements of the Safe Harbor Rule knowing that the work they do would likely need to be redone within a year to address the final SEC rules. As new rules and regulations are presented in waves, the costs of compliance will be compounded and the revitalization of the securitization markets will inevitably be slowed. With reform occurring at several levels and over time, issuers will likely sit on the sidelines until regulatory certainty and stability return.

The regulatory challenges are further exacerbated when you consider that the market will in many cases not be able to tap the unregistered private placement market in situations where new regulations or disclosure requirements will be difficult or impossible to meet. New Regulation AB proposes specific disclosures for private placement transactions that rely on safe harbors set forth in Rule 144A and Regulation D. The Safe Harbor Rule goes even further and provides that transaction documents require that disclosure comply with the requirements of existing Regulation AB, or any successor requirements, "*even if the obligations are issued in a private placement or are not otherwise required to be registered*" (emphasis added). This expansive provision would presumably extend to pure private placements, which do not rely on private placement safe harbors and which the SEC specifically indicated that it did not intend to regulate.

What all this adds up to is an unprecedented level of regulatory change in the securitization market. Combined with the continued uncertainty of future regulations, the ASF believes a private mortgage market could be paralyzed for quite some time. Without knowing the complete regulatory picture or the aggregate burdens associated with securitization, market participants are not able to answer fundamental questions relating to RMBS transactions, including the types of mortgages permitted, the disclosure required, whether safe harbor protection will be offered, whether an accounting sale has occurred or the capital charge to be incurred. 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 this uncertainty is resolved and securitization returns.

Industry Improvements to the Securitization Market Infrastructure

The ASF has been a strong and vocal advocate for targeted securitization market reforms and we continue to work constructively with policymakers to identify and implement them. We believe that any reforms to the securitization market need to be considered and implemented on an interagency basis to ensure that there is a level playing field for all market participants. The ASF is also actively identifying, designing and implementing numerous industry-driven market standards and practice improvements to rebuild and strengthen the securitization infrastructure. It is important that any reform of the securitization market impose mechanisms to encourage appropriate extension of credit to deserving borrowers while not going so far as to inhibit the many benefits of securitization.

In January, 2008, the ASF launched its Project on Residential Securitization Transparency and Reporting ("Project RESTART" or the "Project")[7], which is a broad-based, industry-developed initiative to help rebuild investor confidence in mortgage and asset-backed securities, restore capital flows to the securitization markets, enhance market lending discipline and, ultimately, increase the availability of affordable credit to all Americans. The Project has sought to identify areas of improvement in the process of securitization and refashion, in a comprehensive and integrated format, the critical aspects of securitization with market-based solutions and expectations. 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 appropriate market participant will be recommended to implement. In its March 2008 Policy Statement on Financial Market Developments, the President's Working Group (the "PWG") on the Financial Markets recommended that the ASF develop templates for disclosure in securitization that support efforts to improve market discipline[8] and on June 24, 2008, Acting Under Secretary for Domestic Finance Anthony W. Ryan announced that the PWG had engaged the ASF as the

[7] For more information on Project RESTART, see www.americansecuritization.com/restart.
[8] "Policy Statement on Financial Market Developments," The President's Working Group on Financial Markets (March 2008), page 13. See www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf.

private sector group to develop best practices regarding disclosure to investors in securitized credits.[9] Since its inception, ASF members participating actively in the Project include institutional investors, issuers, originators, financial intermediaries, servicers, rating agencies, due diligence professionals, trustees, outside counsel, outside consultants, data modelers and vendors, as well as ASF's professional staff.

On July 15, 2009, the ASF released final versions of the first two deliverables of the Project, 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 New Regulation AB, which includes loan-level RMBS disclosure and reporting proposals as originally contemplated and designed by Project RESTART.

In connection with the development of the Disclosure and Reporting Packages, the 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. 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 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. The ASF also released a proposed ASF RMBS Bond-Level Reporting Package (the "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.

The ASF also believes that one of the drivers of future success of the RMBS market will be an increase in the standardization of the agreements governing transactions. Capital commitment decisions by loan originators, financial intermediaries and fixed-income investors, as well as risk assessments by rating agencies, are more easily and efficiently made when contractual provisions are relatively consistent across issuers. Increased standardization in a securitization transaction creates additional liquidity in the market because the due diligence process required to make an

[9] Assistant Secretary Anthony W. Ryan, Remarks at Euromoney's Global Borrowers Investors Forum (June 24, 2008). See www.treas.gov/press/releases/hp1053.htm.

investment decision becomes more efficient. For example, the type and form of representations and warranties in past transactions varied greatly, and investors have often complained about a lack of transparency of the representations and warranties given across issuers. Representations and warranties are used to allocate the risk of defective mortgage loans among the mortgage originators, issuers of securities and investors who purchase them. A broad-based working group met extensively to address concerns with existing representations and warranties by providing a baseline set of representations and warranties for RMBS transactions and a more transparent process for determining whether departures from that baseline have occurred in a given transaction. The ASF released on December 15, 2009 the final version of a model set of representations and warranties for RMBS transactions (collectively, the "Model Reps") designed to more clearly allocate origination risks between issuers and investors and provide enhanced investor protections over what had been previously provided in "pre-crisis" transactions.

The ASF is also aware that, for these Model Reps to be effective, the repurchase process in place for breaches would need to be reformulated. Throughout the development of the Model Reps, many deficiencies in the current repurchase process were raised by investors, who believe that most PSAs do not provide a strong enforcement mechanism for the party making the repurchase demand and also do not clearly provide sufficient means and guidance needed to enable the party enforcing a repurchase obligation to pursue such matters. In light of these issues, members of Project RESTART have begun discussing a uniform set of procedures (the "Model Repurchase Provisions") to enforce the Model Reps by, among other things, clearly delineating the roles and responsibilities of transaction parties in the repurchase process and allowing greater access into the mortgage loan files so that breaches can be discovered.

The ASF will also be producing model servicing provisions for PSAs which will create more standardized documentation provisions and work rules in key areas, such as loss mitigation procedures that servicers may employ in dealing with delinquent or defaulting loans.

Covered Bonds Legislation

The ASF membership has broad and near universal support for passage of a legislative framework for US covered bonds, as covered bonds have appreciable potential as a product to encourage additional private mortgage lending by banks. This product offers a distinct securitization alternative to issuers and investors to create more effective market competition for best execution. The legislative framework proposed by Representatives Garrett and Kanjorski would make covered bonds available to most any bank, both large and small. Market forces for pricing and terms would certainly create distinctions between and among different institutions over time, but all banks should have the option of accessing this important potential source of capital.

However, the legislative process of authorizing this product has become a tug-of-war between the product's supporters and the FDIC. The FDIC, while not opposed to the product, is insisting on including the product within the scope of its receivership powers. The FDIC's point, of course, reflects its view regarding the best way to protect the Deposit Insurance Fund (the "DIF").

Although our members certainly respect the importance of protecting the DIF, the FDIC's view regarding the treatment of covered bonds in the case of a depository institution's conservatorship or receivership would keep covered bonds as a seldom used source of funding in a competitive global capital market. Global investors would shun US covered bonds in favor of European covered bonds, since the European bonds would not have the same repudiation risks that the FDIC would impose. As such, the FDIC's powers should be clearly circumscribed with limited powers in the event of the issuing bank's conservatorship or receivership. This identical issue is also raised now by the FDIC on traditional securitizations, which are not structured as covered bonds, given the FDIC Safe Harbor Rule that was announced on Monday. Without overcoming the FDIC's objections and passing covered bonds legislation, a product with real potential to shift burden of housing finance from the government's shoulders to the private sector will never reach its potential. The ASF is willing and able to work directly with the FDIC towards a suitable compromise that would enable the covered bond market to develop into a viable source of financing.

The ASF has submitted, and continues to submit, detailed comment letters on specific, substantive provisions of Dodd-Frank, Covered Bonds legislation, and other legislative and regulatory proposals, and of course the Committee Members and Staff are invited to review and discuss any of these comments with the ASF at any time.

Conclusion

Chairman Frank, Ranking Member Bachus and distinguished Members of the Committee, I thank you again for the opportunity to participate in this hearing on the most serious set of issues facing our mortgage market today and look forward to answering any questions you may have regarding my testimony.

Thank you.

EXHIBIT A

July 21, 2010

VIA E-MAIL

Alastair Fitzpayne, Acting Executive Secretary
Department of Treasury
1500 Pennsylvania Avenue
Washington, D.C. 20220

Re: Reform of the Housing Finance System
(eDocket Numbers TREAS-DO-2010-0001, HUD-2010-0029)

Ladies and Gentlemen:

The American Securitization Forum (the "ASF")[1] submits this letter in response to the Notice and Request for Information (the "Request") issued by the Department of the Treasury ("Treasury") and the Department of Housing and Urban Development ("HUD") seeking public input on establishing a more stable and sound housing finance system.

We appreciate the enormous task Treasury and HUD is preparing to undertake in addressing these issues, which we see as fundamental not only to the securitization markets, but also to the global financial markets and the US economy.

We would also like to note that our comments are being made on behalf of the securitization industry and we are not in a position to address many of the aspects of the housing finance system which Treasury and HUD are planning to review. However, because the bulk of housing finance takes place in the capital markets, via securitization through either the government sponsored entities (the "GSEs") or the private label market, we feel it is appropriate for the ASF to offer its observations with respect to several of the questions listed on the Request. We believe that our responses are consistent with one of the ASF's core values: "to improve the long term health and

[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests in important legal, regulatory and market practice issues. ASF members include over 340 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 initiations. For more information about ASF, its members and activities, please go to www.americansecuritization.com

vitality of the securitization market, and to advance the greater good that securitization provides to consumers, businesses and the economy."

I. The Role of Securitization in the Housing Finance System.

Before addressing the questions listed in the Request, we believe it would be helpful to provide a brief review of several aspects of the nation's housing finance system. In this regard, it is useful to begin with the very basics: the nature of the housing stock, and how it is financed.

The nation's housing stock consists of various types of physical assets: single-family detached homes, townhouses and multifamily structures, which run the gamut from small, owner-occupied and managed two-to four-family structures to the 15,372-unit Co-op City development in the Bronx, New York City. One common characteristic all of these different types of housing structures share is that they are all capital assets, the construction or purchase of which is most appropriately financed through medium or long term debt secured via a security interest in the related real property. Put more simply, the nation's method of financing its aggregate housing stock is via mortgage finance.

A mortgage loan consists primarily of two distinct instruments: a promissory note, which represents the borrower's obligation to pay and a mortgage, deed of trust or long-term lease type document, which creates a security interest in the property that can be enforced by the lender in the event of a borrower default on the note. The note is a fixed-income instrument, suitable for investors seeking a fixed-income return. These investors may be individuals, banks and other financial institutions such as insurance companies, pension funds, the GSEs, or the U.S. Treasury.

A. Government Securitizations.

Prior to the 1970's, the primary source of residential mortgage credit was savings and loan associations. These "thrifts" originated and serviced mortgage loans, and generally held them in their portfolios until maturity or prepayment. The funding for these portfolios was primarily savings deposits.[2]

The consequences of this non-securitized portfolio lending strategy included:

- localized markets, with a high degree of variation in rates and the availability of credit;
- sensitivity on the part of the thrifts to the mismatch between the short-term funding provided by deposits and the long-term (fixed rate) mortgage loans; and
- concentration of mortgage risk in a single industry (thrift industry).

[2] See, generally, Lewis S. Ranieri, "The Origins of Securitization, Sources of Its Growth, and It's Future Potential", in A Primer on Securitization, eds. Leon T. Kendall and Michael J. Fishman (Cambridge, MA.: The MIT Press, 1996).

All of these consequences added up to a market which was limited, segmented and unpredictable, in turn inhibiting the growth in home ownership.

The thrifts' "originate and hold" strategy also had the effect of vertically integrating in a single industry the three principal economic components of mortgage finance. The thrift was the originator of the mortgage loan, the servicer of the mortgage loan and the long term financier of the mortgage loan. The first two of these components are active businesses, requiring management skills and contact with consumer. The third component is essentially passive and requires certain skills relating primarily to the management of financial risks.

These elements of the housing finance system began to change in the 1970's when the "Agency" or GSE market began to develop rapidly. Although government support for the residential housing finance market dates to the Depression, with the establishment of the Federal Housing Administration ("FHA") in 1934, and the Federal National Mortgage Association ("Fannie Mae") in 1938, prior to the 1970's the government's support was primarily limited to loan-level guarantee programs. Fannie Mae was partitioned in 1968 into two parts: the Government National Mortgage Association ("Ginnie Mae"), a federal agency, and a federally-chartered but shareholder owned enterprise still known as Fannie Mae. The Federal National Mortgage Association ("Freddie Mac"), another federally-chartered, shareholder owned enterprise was created in 1970, primarily to serve the thrift industry.

The earlier government support mechanism of loan level insurance through the FHA and the Veterans' Administration (the "VA"), although encouraging thrifts and other lenders to make loans which they otherwise would not, did not fundamentally impact the "originate and hold" strategy. The disaggregation of the three economic components of mortgage finance was however, greatly facilitated by the GSE's creation and participation in the secondary mortgage market.

The "disaggregation" is one of the principal benefits of securitization, as it permits banks and other finance companies to focus on what they do best – originate and service loans. Disaggregation further provides for more efficient matched funding, via the capital markets, for the fixed income instruments which comprise the mortgage notes. Since the underlying fixed income instruments are generally of fairly long term (fifteen to thirty years) a capital market execution also permits time tranching, providing the opportunity for investment at all points along the yield curve, as well as credit tranching, to permit investment all at points along the risk/return spectrum. All of these aspects combine to make securitization the most efficient method of financing the capital assets which make up the nation's physical housing stock, from single-family detached homes to the largest multi-family complexes.[3]

[3] The economic benefits of securitization have been the subject of many academic and scholarly articles. These articles generally have concluded that securitization has positive impacts on the cost and availability of credit, as well as on the dispersion of risk. One recent study, "Study of the Impact of Securitization on Consumers, Investors, Financial Institutions and the Capital Markets" (June 17, 2009), (hereafter, the

B. Private Label Securitizations.

The GSEs have been limited by their charters to the purchase and finance of the "conforming" part of the market, defined primarily by certain credit and documentation standards (such as loan to value ratio), and subject to maximum principal balance limitations. The non-conforming loan mortgage market (the "private label" market) also dates from the 1970's. It really began to come into its own, however, following the passage of the real estate mortgage conduit ("REMIC") legislation in 1986. The private label market serves both the "jumbo" (loans with principal balances in excess of the conforming loan limits) and the "subprime"/"Alt-A" markets (loans which do not meet other standards set by the GSEs).

As a result, from effectively zero in 1970, the percentage of residential mortgage loans securitized in 2007 was roughly 60% for conforming loans, roughly 75% for jumbo loans and roughly 100% for sub-prime loans.[4]

C. The Market Since Financial Crisis.

With the virtual disappearance of the private label market since the onset of the financial crisis, the residential mortgage market has become essentially a government market, with close to 99% of all new residential mortgage finance transactions being through Fannie Mae, Freddie Mac and FHA/VA.[5]

The recent history (at least since the REMIC legislation) of the US housing finance market reveals two broad trends:

- securitization has largely displaced portfolio lending; and
- private label (non-government) securitization grew relative to Agency securitization.

Since the beginning of the financial crisis the first of these trends has accelerated while the second has broken down. Previously dominant private market participants have withdrawn. The GSEs, as mandated by their charters, have not. The GSEs have continued to support liquidity in the secondary mortgage markets by buying into supply when demand is low. Consequently, the market has been able to operate by becoming a government market in terms of issuance and insurance, and largely a government market in terms of portfolio holdings. The ASF's view is that the smooth functioning of the housing finance sector of the U.S. financial market is a national priority and the government's dominant role in the U.S. housing finance system during the recent crisis was both necessary and appropriate.

"NERA Study") was produced by National Economic Research Associates, Inc. at the request of the ASF, and is available at www.americansecuritization.com/uploadedfiles/ASF_NERA_Report.PDF

[4] NERA Study, p. 25.

[5] American Banker article, "Fannie, Freddie and Ginnie at Nearly 100% Market Share", June 2, 2010.

The commercial real estate market provides guidance as to what might have happened to the residential real estate market in the crisis, but for the government's involvement: Generally speaking, the commercial real estate and mortgage markets have not received widespread government support, with the result that credit is unavailable for most types of properties (other than multifamily properties, which are supported to some extent by the GSEs). Much of that market has become an "all cash" market and commercial real estate prices in many areas are currently down to 30-40% of replacement cost. Residential real estate has also suffered a substantial loss of value, particularly in several previously overheated markets.[6] However, the decline in home values, while severe in some markets, has been mitigated across the country by the availability of mortgage credit.

II. <u>Questions for Public Solicitation of Input.</u>

What role should the federal government play in supporting a stable, well-functioning housing finance system and what risks, if any, should the federal government bear in meeting its housing finance objectives?

<u>*GSE Securitizations*</u>. Throughout the financial crisis, the US residential real estate finance market has been financed not only through the government support but also through securitization. Technically, this is because securitization is a nothing more than a financing technique; a government or GSE securitization is still a securitization. A government securitization, however, carries with it a government guarantee, making government securitization fundamentally different from a private label securitization. This is because a government securitization poses, on the investor side, a more narrow set of risks (prepayment, currency and interest-rate) than do private label securitizations, which of course have all those risks plus credit risk, as well as (arguably) more legal and regulatory risks. Of course credit, legal and other risks do not disappear in government securitizations, they merely do not fall on the investors, but rather on the government and thus, ultimately, on the taxpayers. But in terms of structure, disclosure, the need for registration of securities, and various other issues, it appears that the government securitization market is so substantially different from the private label securitization market that the same practices and procedures need not necessarily apply to both markets. Put another way, the government securitization market is more like the Treasury market, and the private label market is more like the corporate bond market.

Another way to view the government securitization market is that its defining characteristic is less its securitization aspect, and more its guarantee aspect. If government securitizations are "secured Treasuries" they should theoretically trade within Treasuries. That has not proven to be the case, suggesting that perhaps the prepayment

[6] See, generally, The Congressional Oversight Panel’s February 2010 Report, “Commercial Real Estate Losses and the Risk of Financial Stability”, pages 27-36, http://cop.senate.gov/documents/cop-021110-report.pdf.

and interest-rate risk associated with the actual, underlying mortgage pool creates more distraction than benefit to the investor community.

The last observation is demonstrated most dramatically when considering the "To-Be-Announced", or "TBA" market, for GSE MBS. A TBA is a contract for the purchase or sale of GSE MBS (e.g., $50 million of 5½% Fannie Mae MBS due in 2040) to be delivered at a future, specified date, sometimes substantially (up to 90 days) in advance of the settlement date. At the time of trade, however, neither the exact pool, number of pools, or loans comprising the pool are known; rather the trade, and in fact this entire market, is made possible only because of the fundamental assumption of the essential homogeneity and the fungibility of GSE MBS.

The TBA market thus allows originators to hedge and fund their forward origination pipelines, since they can originate loans (i.e., "lock in" the rates and prices on the loans) during the period between the trade and the settlement dates.

It is worth noting that what makes the TBA market possible – its homogeneity – is a result of two underlying factors, 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 equalizes all of the securitized MBS in terms of credit risk. In other words, it is probably not possible that the TBA market could be replicated outside of the GSEs, or outside of some replacement of the GSEs that, itself, was able to replicate the two underlying factors of fungible product and uniform credit risk across different originators.

We also observe that many of the reforms being suggested with regard to the private label MBS market – most notably, perhaps, the furnishing of enhanced loan level data to investors – is inconsistent with the operation of the TBA market, since its unique characteristic is that the underlying loans need not even be identified as of the trade date. This again suggests the uniform disclosure and registration requirement for GSE and private label MBS may come at a heavy cost.

Any GSE "reform" which does not accommodate, or suitably replace, the existing GSE MBS TBA market will undoubtedly impact mortgage originators both severely and negatively by reducing the originators' options to "rate lock" and thus satisfy consumer needs. As is always the case, these impacts will surely disproportionately fall on the nation's smaller finance companies as well as the community bank sector

The GSE Portfolios and Securitization. Many commentators have raised questions regarding the policy behind the practice of the GSEs to maintain portfolios.[7] These portfolios consist of both whole loans as well as private label MBS and GSE MBS. The ASF expects this practice of the GSEs to be one of the principal areas of focus as the government undertakes its review of federal housing policy.

[7] See, by way of illustration, Dwight M. Jaffee of the University of California at Berkley, "On Limiting the Retained Mortgage Portfolio's of Fannie Mae and Freddie Mac", June 30, 2005, http:fic.wharton.upenn.edu/fic/papers/05/0538.pdf

Those who are critical of the GSE portfolios frequently suggest that the practice results from the GSEs' historical structure as private, stockholder–owned entities. Under this line of reasoning, enterprise profits can be enhanced with a business strategy of borrowing at a relatively low rate, and investing the proceeds of the debt in higher yielding assets. More specifically, these commentators allege that the GSEs can issue debentures at a taxpayer subsidized rate, and then manufacture arbitrage profits which accrue, not to the taxpayers who make it all possible, but to the far more limited universe of GSE shareholders. Ancillary arguments along these same lines suggest that the GSEs may also engage in relatively risky hedging strategies in an attempt to preserve these arbitrage profits.

Thus, the issue of the GSEs' portfolios is frequently linked as well as to the issues of private ownership of the GSEs and the related profit-maximizing behavior, the suggestion perhaps being that, in the absence of private ownership, there would be no inclination to generate the alleged arbitrage profits and thus no inclination to maintain portfolios. As a consequence, those commentators conclude that the GSEs should perhaps be limited solely to their guarantor function (like Ginnie Mae) and prohibited from maintaining portfolios.

These are very difficult arguments to address, because it is impossible to separate out the two fundamental strains of reasoning supporting the argument: one based on the profit-maximizing inclination of privately owned enterprises, and one based on an alleged misuse of a taxpayer-supported benefit. The ASF is certainly not today in a position either to support or criticize the practice of maintaining GSE portfolios.

We would urge the government in considering this complex issue to keep in mind two very broad principles. First, the recent financial crisis has demonstrated that anything which maximizes the options available to the government is probably a positive rather than a negative, under the general proposition that more options are better than fewer.

What follows from this first principle is that any hard and fast policy prohibiting the maintenance of GSE portfolios is also a policy which narrows the universe of available options. The maintenance of portfolios is not necessarily inexorably linked with the question of private versus public, or some sort of hybrid ownership structure.

Our second observation is that the maintenance of GSE portfolios funded by GSE debentures tends to retain relatively more risk on the GSEs and their owners than do GSE securitizations (i.e., transactions in which the GSEs act only as guarantors). To the extent that the maintenance of the portfolios arguably give rise to "arbitrage profits", it is useful to remember that profits are economically the flip side of risk, which in the case of the GSE portfolios are primarily prepayment and interest rate risks. A GSE securitization strategy, as compared to a GSE portfolio strategy, will tend to transfer both prepayment and interest rate risk to the investors, rather than retain these risks at the GSEs and their owners; this is true whether those owners are private shareholders, the government, or some hybrid.

Private Label Securitization Market. An important element of government housing policy is the regulatory architecture governing securitization. As is well known, the financial crisis has precipitated a number of reform proposals. The government has issued several proposed rules, and the securitization industry has developed a variety of initiatives, aimed at both the securitization market and the broader structured products industry. The ASF will comment on many, if not all of the government proposed rule-makings. Consequently, we will not repeat here our observations on those more targeted letters, but rather will set forth our views on several fundamental points, in particular:

- much of the source of financial crisis seems attributable to an overheated real estate market; and

- a rising real estate market increases lenders' willingness to provide credit, and borrowers' willingness to take on debt.

The Structure of Mortgage Credit as a Fixed-Income Investment. With respect to the residential mortgage sector, there are generally considered to be two aspects to a lender's underwriting analysis: the borrower's ability to repay, and the likelihood that the collateral value of the real estate will be sufficient to satisfy the debt in the event of a borrower default. This point is driven home with particular clarity in so-called "single-action" states, where, by law, upon a borrower's mortgage default, the lender must choose between an action against the borrower on the note (i.e., an action against the borrower's personal credit) and on action against the mortgaged property (i.e., foreclosure and sale). Not surprisingly, and, indeed, entirely sensible is the phenomenon that a lender would be more inclined to extend credit on a secured loan (such as a mortgage) when the value of the collateral is, by all available indications, on the rise. Put another way, if a loan is secured by both personal credit and collateral, a strong collateral position will put a lender in a position to make more accommodations regarding the borrower's personal credit strength, and vice-versa. Consequently, one would expect relatively more emphasis on collateral value when collateral values are rising, and less emphasis on personal credit.

As noted at the outset of this letter, securitization, as a technique, works best when the underlying assets are themselves debt or debt-like instruments with predictable and scheduled cash flows. The securitization technique also works with less predictable cash flows, for example, the case of "liquidating trusts" where the assets are, from the outset, foreclosed or seriously delinquent real estate properties. In these structures, however, the securitization's cash flows become relatively unpredictable, and time and credit tranching become difficult since recovery periods and rates are uncertain. As a result, the securities issued in a liquidating trust structure tend to be on the more speculative side of fixed-income investments – in effect, equity type investments structured as fixed-income investments. As a general principle of finance, the difference between equity investments and fixed income investments is rather fundamental, so any misapprehension (or outright confusion) as to whether an investment is an equity versus a fixed-income investment is likely to lead to substantial mis-pricing and inefficiency. An investment backed by real estate properties would generally be considered an equity type investment, whereas an investment backed by promissory notes would generally be considered a fixed income investment – the investments in effect take on the character of the underlying assets which service the investment. Thus investments which rely heavily on "the future" and/or "management" are essentially equity investments not ideally suited to classical securitization.

What this line of reasoning means for government policy in the housing finance system is simply this: state or federal law policies which relieve consumers from personal liability for mortgage debt, such as a "single-action" rules, tend to make residential real estate lending relatively more like equity and relatively less like debt. Since the securitization market is at its most efficient as a fixed-income market, then, other things being equal, the more emphasis there is on borrower credit, as represented by the promissory notes, and the less emphasis there is on the real estate, the more efficient the securitization structure becomes.

Many commentators on the recent crisis acknowledge the contributing roles of the real estate bubble and of the securitization market, and also the likely fundamental truth that bubbles will always be with us, and they can only be seen, at least by most of us, when they pop. Hence in the narrow area of real estate finance, the best solution is probably a structural one, to encourage both borrowers and lenders to focus relatively more on personal credit, and relatively less on real estate values, thus helping to re-order the housing finance system, at least as regards securitization, more strongly to a proper fixed-income market.

General Regulatory Uncertainty. Today, the President just signed the Dodd-Frank Act, which impacts the securitization markets primarily through the risk retention and credit rating agency reform provisions, although other aspects of the Act, particularly as regards resolution regimes for financial institutions and consumer protection, also have the potential for huge, if indirect, impacts on this market. Many important details of implementation have been left to a variety of federal agencies, including the SEC, HUD, the FDIC, the Federal Housing Finance Agency, the OCC and the Federal Reserve. The legislation mandates various time frames for regulations, generally one or two years following enactment. In addition, both the previously-introduced covered bond legislation, as well as the not-yet taken up issue of GSE reform have the potential to alter vastly the regulatory landscape for the securitization industry.

Apart from this legislation, the SEC has recently promulgated a variety of new regulations regarding credit rating agencies and the ratings of "structured finance products", and is in the process of revising the principal regulation relating to securitizations, Regulation AB -- a process that will likely continue for another six months to a year.[8] Meanwhile, the FDIC is currently in the process of revising its legal isolation safe-harbor regulation for securitizations, 12 CFR 360.6, primarily in response to accounting changes which themselves remain in flux.[9]

With regard to the judicial system, recent court decisions as well as pending cases also add to the pervasive sense of uncertainty in the securitization markets. Among the more

[8] Securities Act Release No. 9117 (April 7, 2010), published in the Federal Register on May 3, 2010.
[9] Federal Register, Vol. 75, No. 94, May 17, 2010, p. 27471.

notable cases are the Dante[10] and Metavante[11] decisions from the Lehman bankruptcy, the General Growth Properties ruling regarding the "adequate protection" doctrine in bankruptcy,[12] and the SEC's action against Goldman Sachs relating to disclosure issues in the Abacus CDO transaction.[13]

It goes without saying that all of these legislative, regulatory and judicial actions are important and well-merited in their own right, and that the issues are complex and require both time and substantial thought. Nevertheless, that having so many different bites being taken at essentially the same apple by so many different governmental bodies – and indeed, different branches of government – is not a recipe for a quick revival of the securitization markets and/or the nation's system of housing finance. Government officials from the Treasury Secretary[14], the Federal Reserve Chairman[15] and the FDIC Chairman[16] on down have all made the point that a revival of the securitization markets is a necessary condition to a revival of the U.S. economy. Given all the different tracks on which these government actions are currently traveling, the visible supply of legal and regulatory uncertainty extending out over the securitization markets for the next two years at least seems to indicate that a full economic recovery is also at least that far off.

In light of this, the ASF strongly believes that federal housing finance policy should work to restart the non-agency residential mortgage secondary market in a rational and coordinated way. Regulatory uncertainty, among other things, is presently frustrating the ability of originators to develop a sound business strategy in the non-conforming product. Market regulation of securitization transactions should promote a sustainable non-agency securitization market. This should be done in a collaborative and coordinated way, which facilitates the core credit intermediation functions of banking organizations. We believe that a single, national standard arising out of the Dodd-Frank Act, and implemented by joint interagency regulatory rulemaking will best achieve the housing finance policy goals of promoting responsible underwriting and market transparency, while addressing the need of industry participants to have a clear, practical and efficient approach. A fragmented approach to regulating these markets, in which various regulatory bodies (and, indeed, all three branches of government) develop slightly different rules governing the exact same subject matter, is unlikely to produce efficient results and prove to be a drag on the mortgage market.

---

[10] See “Bankruptcy Judge Invalidates Securitization Payment Structure”, HousingWire, January 29, 2010, http://www.housingwire.com/2010/01/29/bankruptcy-judge-invalidates-securitization-payment-structure.

[11] See “The Specter of Lehman Shadows Trade Partners”, Wall Street Journal, September 17, 2009, http://online.wsj.com/article/SB125313981633417557.html

[12] See “General Growth: Bankruptcy and the Downfall of Securitization as We Know It”, (Westlaw Business, Legal Currents, May 5, 2009, http://currents.westlawbusiness.com/Articles/2009/07/20090728_0053.aspx?cid=&src=

[13] See “SEC Split Over Goldman Deal”, Wall Street Journal, July 17, 2010, http://online.wsj.com/article/SB10001424052748704229004575371601322076426.html

[14] Secretary Geithner’s remarks on “Meet The Press”, March 29, 2009, reported at http://seekingalpha.com/article/128432-straight-talk-from-geithner-on-securitization

[15] Chairman Bernanke quoted at the Federal Reserve Bank of Chicago meeting’s question and answer session, May 6, 2010, reported at http://www.reuters.com/article/idUSWEN433720100506

[16] Chairman Bair’s remarks to the Housing Association of Non-Profit Developers Annual Meeting, Tyson’s Corner, Virginia, June 7, 2010, http://www.fdic.gov/news/news/speeches/chairman/spjun0710.html

Risk retention mandates associated with residential mortgage credit risk need to be practical and flexible, and need to recognize that there are many paths to the mountaintop. Various policy proposals have been advanced by Congress (through the Dodd-Frank Act), the FDIC, the SEC, and others. While each proposal addresses the same subject matter and each share certain elements, these proposed standards are all different. To the extent that risk retention is required, the Dodd-Frank Act authorizes regulators to determine whether it is to be accomplished in a particular way such as for example a pro-rata vertical slice, a first-loss interest, holding similar loans on balance sheet in unsecuritized form, or other reasonable methods. High-quality qualified residential mortgages will be exempt. Also, reasonable standards concerning sunset provisions and permitted hedging should be considered. Further study should be undertaken to determine how best to approach risk retention, its consequences to balance sheets and bank capital, as well as a review of its potential macroeconomic effects. A "one-size-fits-all" approach is unlikely to produce the best results.

As the markets heal, private organizations should increasingly be encouraged to participate in the non-agency securitization markets. If banks continue to refrain from non-agency securitization activity, concentrations of mortgage credit risk appear likely to continue to reside within the FHA and Ginnie Mae, within the GSEs, and with other governmental or quasi-governmental bodies. Responsible, user-friendly non-agency securitization markets should be viewed as a tool to help gradually reduce concentrations of these risks in governmental agencies, as well as transferring these risks outside of the banking system.

To the extent the process of resolving the legal and regulatory uncertainties surrounding securitization can be co-ordinated and (not unduly) accelerated, the revival of the housing finance system and of the U.S. economy in general will happen sooner rather than later.

Do housing finance systems in other countries offer insights that can help inform US reform choices?

The ASF strongly supports the view that the US should consider systems, and individual aspects of systems, of housing finance from other jurisdictions. Three broad areas for consideration suggest themselves:

- different cultural notions of the desirability of home ownership;
- with respect to residential housing finance, product offerings and imbedded issues of risk allocation; and
- alternative securitization products, and covered bonds in particular.

Home ownership. Treasury and HUD have solicited public comment on the issue of a federal housing policy for "sustainable home ownership". This is perhaps the broadest of the questions posed by the notice, and although, once again, the ASF has no special wisdom on this bedrock issue, we will offer some broad observations on home ownership, consumer credit and the capital markets.

As noted earlier in this letter, there are three basic forms of the hard assets which make up this nation's or any nation's physical housing stock: single-family detached, townhouse and multifamily (both small and large complexes). Although "home ownership" is not synonymous with "single-family" detached homes, there is enough truth to that to make it useful to see the two things as synonymous. Viewing the issue a different way, however, leads to considering the home ownership issue not as an issue of the type of housing unit; but rather as the "owner" versus the "renter" model, where the primary difference, arguably is whether the unit's inhabitant has any equal investment in the "bricks and mortar" which make up the unit. In many people's minds, these two different ways of seeing "home ownership" collapse, and become fused in the notion that one "buys a home" (single-family detached or townhouse) and one "rents an apartment".

Certainly the notion that home ownership is a desirable goal seems deeply imbedded in the yet broader notion of the "American Way of Life". This notion serves as the marketing principle for both the GSEs as well as many depository and non-depository lenders.

Beyond "home ownership" as a marketing principle for the residential mortgage industry, such a principle fits in nicely with the even broader concepts of consumer spending and consumer credit. It seems commonsensical to conclude that there is probably some sort of a direct correlation between the size of one's housing unit (or units) and one's appetite for spending on large purchases such as autos and appliances. Many such purchases are likely financed, at least in part, on credit. Thus, it is probably the case that "home ownership" correlates with not only increased mortgage credit but also increased consumer spending and consumer credit. Since roughly 70% of the U.S. economy is based on the consumer sector[17], any large-scale effort to redefine "the American Way of Life" away from home ownership should take into account any broader potential impact on the American economy.

Another fundamental observation about "home ownership", at least insofar as it means the single-family detached unit, is that it is likely the most environmentally expensive way to meet the nation's housing needs. This is true for many of the same reasons "home ownership" promotes increased consumer spending: single-family detached homes compared to say, large multi-family buildings likely promote more autos, more appliances, heavier energy usage, and so on.

Residential housing finance product mix. Via the process of securitization, risks can be allocated between the issuer/sponsor on the one hand and the investors on the other hand (and among different investors through tranching). But an even more fundamental risk allocation is between the consumers on the one hand and the issuer/sponsor/investors on the other hand, and examining that risk allocation through a consideration of the product mix may be a worthwhile exercise.

---

[17] "Consumer Credit in U.S. Declined More Thank Forecast", Bloomberg Business Week, July 8, 2010, http://www.businessweek.com/news/2010-07-08/consumer-credit-in-u-s-declined-more-than-forecast.html

It is fair to say that the standard, benchmark residential product in residential housing finance is the 30-year fixed rate mortgage with limited prepayment penalties. It is also fair to say that this product is essentially a U.S. product, of limited availability in other countries, where shorter-term and adjustable rate loans are far more common.

As noted above, the 30-year fixed rate product transfers interest rate and prepayment risk (refinancing risk when seen from the borrower's perspective) from the borrower to the investor. By comparison, a five-year adjustable rate loan would retain more interest-rate and refinancing risk on the borrower. Particularly if coupled with enhanced legal rules which solidify the personal liability of borrowers on their residential mortgage loans, the specter of a looming need to refinance may lead, structurally, to more conservative lending and borrowing practices in the residential mortgage finance space. The flip side of more risk retention by the borrower is less risk to the investor, whether the investor is a GSE or a private investor.

Another variable in mortgage products relates to the use of loan proceeds. In this area, the big divides are between purchase-money versus refinance or equity take out, and owner occupied versus non-owner occupied. Although all of these products are available in other jurisdictions, the primary question for the U.S. perhaps is whether products other than owner occupied, purchase – money residential housing finance transactions should benefit from any sort of government support, including eligibility for federally-provided insurance or GSE purchase. Since government mortgage insurance and entities such as Fannie Mae and Freddie Mac are by and large U.S. creations not found in other jurisdictions, these product characteristics are not directly susceptible to a cross-jurisdiction review, but are worthy of consideration by the government in terms of the federally supported residential product mix.

Covered Bonds. Covered bonds are the primary securitization product from abroad which is under discussion in the U.S. Several years ago, the FDIC provided regulatory guidance on the product[18], and a bill has been introduced in the House to further solidify the legal underpinnings of the product[19]. Among knowledgeable observers, an enhanced legal regime for US covered bonds has wide support, and as a general matter the ASF supports covered bonds. Covered bonds are a popular securitization-style method of financing for housing in a number of other jurisdictions, and in Europe have been used for over a century. Covered bonds are a bank product (as distinguished from a product issued by non-depository finance companies) although this is only true as a historical matter. There is no apparent market or legal rationale which would prevent covered bonds being issued by entities other than banks (e.g., Fannie Mae, Freddie Mac or non-depository finance companies).

Although the structure is more complex, covered bonds are essentially secured debt of a bank, with the collateral being a "cover pool" of financial assets (such as mortgages). Unlike in a classical securitization, the cover pool is not a static pool, and the bonds do

[18] "FDIC Policy Statement on Covered Bonds", August 4, 2008, http://www.fdic.gov/news/news/financial/2008/fil08073.html

[19] The "United States Covered Bond Act of 2010", introduced March 18, 2010, Rep. Scott Garrett of New Jersey.

not amortize based upon the pool's amortization -- the structure is more like corporate debt (i.e., bullet maturities). Covered bonds, since they structurally provide for "skin in the game" (because the issuing bank as fully liable for credit risk), are a particularly attractive product for consideration in the U.S. at this time, especially in light of the much criticized "originate to distribute" practice allegedly prevalent in the residential market during the pre-crisis years. As stated above, the ASF is generally supportive of making covered bonds available as an alternative capital markets method of financing housing (and other forms of) credit in the U.S. However, there is one principal point the ASF would like to make about covered bonds.

It is likely the case that one principal reason why covered bonds have not previously played a large role in the U.S. is because of the presence of the GSE's, which are uniquely U.S. constructs. Put another way, no jurisdiction has entities similar to Fannie Mae, Freddie Mac and the Federal Home Loan Bank System and a meaningful covered bond market. This could suggest that these may be two different ways to support mortgage finance, and how these techniques may co-exist is not something on which any other jurisdiction provides much guidance.

Consequently, ASF's only observation is that, while covered bonds appear to be a promising idea for the U.S., care should be given to the implementation of the idea in the U.S.

* * * * *

We very much appreciate the opportunity to offer our observations on these issues of true national importance. We further understand that the Government is only at the very beginning of the process of its review, and we offer to the Government in advance continued access to the American Securitization Forum's member resources and expertise as the process continues. Should you have any questions concerning our observations, or if you feel we may further assist you in this task, please do not hesitate to contact me at 212.412.7107, tdeutsch@americansecuritization.com, or our outside advisors on this matter, Armando Falcon of Falcon Capital Advisors, LLC at 202.393.4150, afalcon@falconhfg.com, or Chris DiAngelo of Dewey LeBoeuf LLP at 212.259.6718, cdiangelo@dl.com.

Sincerely,

Tom Deutsch

Tom Deutsch
Executive Director
American Securitization Forum