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**Written Testimony of**

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Before the  
House Financial Services Committee

“A Legislative Proposal to Protect American Taxpayers and Homeowners by Creating a Sustainable Housing Finance System”

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## Witness Background Statement

**Adam J. Levitin** is a Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in structured finance, consumer finance, bankruptcy, contracts, and commercial law. Housing finance and securitization is a major focus of his scholarship.

Professor Levitin has previously served as the Bruce W. Nichols Visiting Professor of Law at Harvard Law School, as the Robert Zinman Scholar in Residence at the American Bankruptcy Institute, and as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP). Professor Levitin currently chairs the Mortgage Committee of the Consumer Financial Protection Bureau's Consumer Advisory Board.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College. In 2013 he was awarded the American Law Institute's Young Scholar's Medal.

Professor Levitin has not received any Federal grants nor has he received any compensation in connection with his testimony, and he is not testifying on behalf of any organization. The views expressed in his testimony are solely his own.

Mr. Chairman Hensarling, Ranking Member Waters, Members of the Committee:

Good afternoon. Thank you for inviting me to testify at this hearing. My name is Adam Levitin, and I am a Professor of Law at the Georgetown University, where I teach courses in structured finance, consumer finance, bankruptcy, and commercial law. I also chair the Mortgage Committee of the Consumer Financial Protection Bureau's Consumer Advisory Board and am a member of the Mortgage Finance Working Group sponsored by the Center for American Progress, which has put forth a proposal for GSE reform. I am here today, however, as an academic who has written extensively on housing finance and am not testifying on behalf of the CFPB, the Consumer Advisory Board, or the Mortgage Finance Working Group.

Today's hearing is focused on the Protecting American Taxpayers and Homeowners Act of 2013 (the "PATH Act"), a massive bill that proposes wide-ranging and radical reforms in the housing market. Unfortunately, the PATH Act is a path to ruin. The PATH Act takes us back to the future in the housing finance, encouraging the revival not only of predatory lending practices but also the structural problems that plagued the pre-New Deal housing finance market.

As the PATH Act is such an extensive bill, I do not attempt to address all of it in my written testimony. In particular, my written testimony does not generally address title II of the PATH Act dealing with the reform of FHA. Instead, my written testimony is focused on the PATH Act's provisions for winding down Fannie Mae and Freddie Mac and creating a new secondary market infrastructure.

In the ideal world, I would unequivocally prefer to see the U.S. housing finance system financed entirely with private capital. The government's involvement in the U.S. housing finance system carries with it serious concerns of moral hazard and politicized underwriting. Yet proposals like the PATH Act that would eliminate *any* government guarantee from the housing finance system are not a solution. Despite privatization's ideological appeal, **there is a fundamental problem with privatization proposals for the housing finance system: they don't work. Fully private housing finance systems simply do not exist in the developed world.** Every developed economy either has an explicit or implicit guarantee of its housing finance system, and there is every reason to favor an explicit guarantee, which can be prudently structured and priced, rather than an implicit guarantee.

Following the siren's song of privatization would take us back to the "Head– Wall Street wins; Tails–Main Street loses," world of pre-2008. Privatization would result in most American families being unable to obtain 30-year fixed-rate mortgages or lock in rates before closing. And privatization would place entire U.S. economy in grave peril because there is nowhere close to the sufficient private risk capital willing to assume credit risk on U.S. mortgages. Prudence and reality both dictate what is the consensus position: there needs to be some form of limited, explicit government guarantee in the housing finance market.

The PATH Act ignores this sensible consensus in favor of a bill that is both radical and reactionary:

- The PATH Act proposes a total privatization of the housing finance system despite the lack of private capital to support it. The result could be disastrous.
- The PATH Act makes 30-year fixed-rate mortgages difficult to obtain.
- The PATH Act makes it difficult for homebuyers to lock in interest rates prior to closing.

- The PATH Act breaches the federal debt ceiling.
- The PATH Act recreates the too-big-to-fail problem with covered bonds.
- The PATH Act encourages predatory lending by eliminating key Dodd-Frank anti-predatory lending provisions.
- The PATH Act bullies municipalities attempting to mitigate the foreclosure crisis by threatening to cut them out of the housing finance system.
- The PATH Act radically and possibly unconstitutional federalizes and then privatizes the real property recording system.

For all of these reasons, the PATH Act is the wrong path to follow for housing finance reform.

## **I. OVERVIEW OF THE PATH ACT'S GSE REFORM PLAN**

The PATH Act would have the GSEs cease doing new business within five years and instead replace them with a National Mortgage Market Utility (the “Utility”).<sup>1</sup> The Utility would be privately-owned and operated, but subject to supervision by the Federal Housing Finance Authority.<sup>2</sup> The Utility would operate an optional Common Securitization Platform that it would have purchased from the GSEs, which are tasked with its development.<sup>3</sup> Significantly, this Utility would not itself actually issue MBS and would be forbidden from guaranteeing MBS.<sup>4</sup> Instead, the Utility would set standards for issuance of MBS. MBS that conform to these standards would be considered “qualified securities” upon payment by the issuer of a fee to the Utility.<sup>5</sup> The Utility would also operate a National Mortgage Data Repository (the “Repository”)—basically a giant privately-run national recorder of deeds office.

Thus, what the PATH Act envisions is private financial institutions aggregating mortgage loans and issuing MBS under the platform’s rules and standards and using the Repository for recording their mortgage or deeds of trust. “Qualified securities” issued under the Utility’s standards would be exempt from the Securities Act’s registration requirements,<sup>6</sup> from the Consumer Financial Protection Bureau’s Qualified Mortgage (QM) rulemaking,<sup>7</sup> and exemption from state law evidentiary requirements for foreclosures.<sup>8</sup> Significantly, nothing in the PATH Act prohibits financial institutions from engaging in mortgage securitization outside of the Utility.

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<sup>1</sup> PATH Act §§ 104(a), 110.

<sup>2</sup> PATH Act §§ 310-311.

<sup>3</sup> PATH Act § 313. The appropriateness of the valuation for the purchase price of the Platform is likely to be questionable. Section 313(a) of the PATH Act requires the FHFA Director to “agree on a valuation of the Platform upon transfer to the Utility.” In other words, there is no market test of the valuation of the Platform, but simply a deal in the context of a bilateral monopoly. There is a good possibility that this will result in a sweetheart deal for whatever private party is selected to operate the Platform.

<sup>4</sup> PATH Act § 312(c).

<sup>5</sup> PATH Act § 312(b). This standard-setting function is similar to what Ginnie Mae does. Ginnie Mae does not actually issue securities. Instead, it guarantees securities that conform to its underwriting requirements. Ginnie Mae securities are privately issued.

<sup>6</sup> PATH Act § 343.

<sup>7</sup> PATH Act § 342 (substituting a FHFA QM rulemaking for the CFPB rulemaking).

<sup>8</sup> PATH Act § 332.

The PATH Act would have FHA continue to operate with a focus on underserved markets,<sup>9</sup> but with drastically reduced insurance coverage: the FHA would provide no coverage for the first two years of the loan,<sup>10</sup> then 70% coverage in year three, 60% in year four, and 50% coverage thereafter,<sup>11</sup> instead of its current 100% coverage for the life of the loan. Lenders will likely charge higher rates to offset for this reduced coverage. The reduced coverage combined with potentially risk-based pricing<sup>12</sup> will make FHA loans a much less attractive option for borrowers and means that FHA will likely be a very small part of the market.<sup>13</sup>

## **II. THE ILLUSION OF WHOLLY PRIVATE HOUSING FINANCE SYSTEMS**

The PATH Act represents an attempt to return to a wholly-private housing finance market, with all credit and interest rate risk on mortgages borne by private parties. Unfortunately, a truly private housing finance system is a pipedream. It simply does not exist in any developed country in modern times and never has. Every developed country either explicitly or implicitly guarantees some part of its housing finance system, and in the United States it is government involvement in the market that makes the long-term fixed-rate mortgage widely available. In some countries, like Canada, the guarantee is explicit—and priced—and the market is regulated to protect the government from excessive risk exposure. In other countries, the guarantee is implicit.<sup>14</sup> It is difficult to prove an implicit guarantee; the very nature of it is that

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<sup>9</sup> PATH Act § 212.

<sup>10</sup> PATH Act § 264.

<sup>11</sup> PATH Act § 234.

<sup>12</sup> PATH Act § 235(d).

<sup>13</sup> The PATH Act fails to reconcile reduced FHA coverage with the operations of Ginnie Mae. Ginnie Mae is subrogated to claims on FHA insurance policies when it pays on its bond insurance. Unless Ginnie Mae coverage is reduced to match reduced FHA coverage, Ginnie Mae will end up with the short-end of the stick or have to charge more for its insurance or reduce its insurance coverage, which would make Ginnie Mae MBS significantly less attractive to investors.

<sup>14</sup> Proponents of privatizing the housing finance system and eliminating the government guarantee will generally point to Germany and Denmark as examples of housing finance systems without a guarantee that have widely available long-term, fixed-rate mortgages. E.g., Peter J. Wallison, *A New Housing Finance System for the United States*, Mercatus Center Working Paper No. 11-08, at [http://mercatus.org/sites/default/files/publication/wp1108-a-new-housing-finance-system-for-the-united-states\\_0.pdf](http://mercatus.org/sites/default/files/publication/wp1108-a-new-housing-finance-system-for-the-united-states_0.pdf), at 10 (“Neither Denmark nor Germany backs any part of the mortgage financing system, which seems to work well because of the regulatory assurances of mortgage quality.”). Unfortunately, this view of the German and Danish housing finance systems is incorrect. Germany and Denmark both turn out to have been latent implicit guarantee cases prior to October 2010, at which point they became examples of explicit guarantees.

In October 2008, Germany created a Teutonic TARP known as the “Special Fund Financial Market Stabilization,” or SoFFin (its German acronym) to bail out its banks. SoFFin provided nearly €150 billion to support ten financial institutions’ liabilities, including those of three covered bond issuers and three Landesbanks (another type of German mortgage lender). See Bundesanstalt für Finanzdienstleistungsaufsicht, “Annual Report of the Federal Financial Supervisory Authority” (2008), available at [http://www.bafin.de/clin\\_152/nn\\_720486/SharedDocs/Downloads/EN/Service/Jahresberichte/2008/annualreport\\_08\\_complete.templateId=raw.property=publicationFile.pdf/annualreport\\_08\\_complete.pdf](http://www.bafin.de/clin_152/nn_720486/SharedDocs/Downloads/EN/Service/Jahresberichte/2008/annualreport_08_complete.templateId=raw.property=publicationFile.pdf/annualreport_08_complete.pdf).

Denmark also announced a broad guarantee of all deposits and senior debt issued by its banks in October 2008. See Neelie Kroes, “Guarantee scheme for banks in Denmark,” European Commission Memorandum, State Aid NN51/2008 – Denmark,” available at [http://ec.europa.eu/community\\_law/state\\_aids/comp-2008/nn051-08.pdf](http://ec.europa.eu/community_law/state_aids/comp-2008/nn051-08.pdf). Denmark has a robust mortgage lending system financed by covered bonds—bonds issued by banks against mortgage collateral held on balance sheet. Formally, the Danish guarantee did not apply covered bonds, only to the deposits and senior debts of the banks that issued them. The functional reality of this arrangement, however, was to guarantee the covered bonds by guaranteeing that the issuers would have sufficient assets and liquidity to meet their

there is no clear proof. One can look at spreads between mortgage debt and government debt, for example, but that is not necessarily conclusive. Indeed, in the United States, GSE debt was explicitly *not* guaranteed by the federal government...until it was.

Try as we may, we cannot escape either history or the reality that the U.S. government will always bailout its housing finance system if it gets into trouble. We did that in 1932-34. We did so in 1970 by letting Fannie Mae purchase conventional mortgages and creating Freddie Mac with conventional mortgage authority. We did it with the S&Ls in the 1980s. We did it again in 2008. Catastrophic risk in housing finance is inevitably socialized, so it is best to recognize that truism and adapt our regulatory system to mitigate the risk. Pretending that is won't happen again is hardly a solution.

We do not have to like the existence of a government guarantee in housing finance. But the choice we face is between an implicit and an explicit guarantee, not between a guarantee and no guarantee. All government guarantees have clear problems—moral hazard because the government holds the credit risk, while private parties hold the upside, and the danger of politicized underwriting.

There are ways to try to guard against both problems. For example, moral hazard can be alleviated through use of deductibles and copayments—have first-loss private risk capital or loss splitting between the government and private capital. Administrative structures can guard against politicized underwriting. Those risk mitigants, however, require an explicit guarantee.

For better or worse, though, we need to accept that *some* form of a government guarantee, even if only for catastrophic losses, is required in our housing finance system. It cannot be confined to an FHA niche, but needs to be system-wide in part because of the serial correlation of housing prices and credit risk. The unique nature of housing finance as an enormous asset class that affects a wide swath of citizens and economic and social stability means that no U.S. government will permit the market's collapse: it would be economic and political suicide. The question then is not whether there should be a guarantee—we have one whether we want it or not—but how it should be structured.

### **III. THE PATH ACT SETS THE STAGE FOR A RETURN TO UNREGULATED PRIVATE-LABEL SECURITIZATION**

The PATH Act aims to create a *regulated* private-label securitization market. To be sure, this regulation is supposed to be done through a privately-owned utility, rather than through the government, but it is regulation nonetheless, just of the outsourced variety, much like the credit ratings agencies.<sup>15</sup> A regulated private-label securitization market is a reasonable approach to housing finance, but it is only as good as that regulation. To the extent that parts of the market are not regulated there will be seepage from the regulated to the unregulated space, much as happened with “shadow banking” and with the disastrous shift from Agency to unregulated private-label securitization in 2003-2007.

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covered bond payment obligations so that the covered bondholders would never have to look to their cover pools of collateral for recovery.

<sup>15</sup> It is troubling that the rules affecting such a large swath of the U.S. economy would be exempt from notice-and-comment rulemaking and judicial review.

The PATH Act, however, eliminates the Dodd-Frank Act’s regulation of the private-label securitization market—the so-called “skin-in-the-game” credit risk retention requirement.<sup>16</sup> The PATH Act also prohibits the regulatory imposition of credit risk retention requirements<sup>17</sup> and suspends the SEC’s Reg AB II rulemaking that is intended to ensure better disclosure of information about securitizations to investors.<sup>18</sup> So far there have been no rulemakings under the skin-in-the-game requirement. While one might debate the wisdom of the particulars of a rule-making, the requirement of some type of skin-in-the-game for some securitizations is reasonable—indeed the market already requires it in some securitizations.<sup>19</sup>

The PATH Act does not substitute improved regulations for the ones it eliminates. Thus the PATH Act would return the private-label securitization market outside of the Utility to a virtually unregulated state, just as it was during the housing bubble.

In place of improved regulations for the entire private-label securitization market, the PATH Act substitutes *optional*, outsourced regulation. The PATH Act does not require that all private-label securitization be regulated, only that securitization done using the Utility be regulated by the privately-owned, but federally overseen Utility. Thus, banks are free to operate their own, unregulated securitization platforms, just as they did during the housing bubble.

The PATH Act attempts to encourage use of the Utility and thus regulated private-label securitization through a set of carrots. None of these carrots are sufficiently appetizing to matter, much less to offset the costs imposed by use of the PATH Act Utility. As a result, no one will use the PATH Act Utility. Banks will simply engage in unregulated private-label securitization outside of the Utility. The PATH Act is building a National Mortgage Market Utility to nowhere.

Of the benefits that come with using the PATH Act utility, the only one of real substance is exemption from the Securities Act’s registration requirements, which is a prerequisite for a to-be-announced (“TBA”) market.<sup>20</sup> Private label securitization was previously able to compete against registration-exempt GSE securities in the past and to operate without a TBA market (as does the rest of the developed world). The costs and hassle of registration are not large enough to make use of the Utility attractive and offset its fees and mandatory standards.

The PATH Act’s other carrots are similarly insignificant. The exemption of “qualified securities” issued using the Utility from the CFPB’s Qualified Mortgage (“QM”) rulemaking that creates an exemption from the Dodd-Frank Act’s ability to repay requirement is not much of a boon for securitization sponsors given that the PATH Act also eliminates the QM enforcement provision for *all mortgages*.<sup>21</sup> Similarly, exemption from state law evidentiary requirements for foreclosures,<sup>22</sup> is not of much consequence, as traditionally foreclosure rates are about 1% and relatively few foreclosures are determined by the technical state law evidentiary requirements. In short, it’s not clear why anyone would use the PATH Act Utility. Instead, we are likely to see

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<sup>16</sup> PATH Act § 407(a) (repealing Dodd-Frank Act section 941, *codified at* 15 U.S.C. § 78o-11).

<sup>17</sup> PATH Act § 407(b).

<sup>18</sup> PATH Act § 405.

<sup>19</sup> Adam J. Levitin, *Skin in the Game: Risk Retention Lessons from Credit Card Securitization*, 81 GEO. WASH. L. REV. 813 (2013).

<sup>20</sup> PATH Act § 343.

<sup>21</sup> PATH Act § 410 (eliminating section 1413 of the Dodd-Frank Act, which provides the remedy for failure to ensure ability to repay when making a mortgage loan). *See infra* section VIII for discussion.

<sup>22</sup> PATH Act § 332.

the GSEs replaced by unregulated private-label MBS and covered bonds. Both have problems, the foremost of which is the lack of market demand for mortgage credit risk.

#### **IV. LACK OF MARKET DEMAND FOR MORTGAGE CREDIT RISK**

A mortgage carries two types of risks for investors: credit risk and interest rate risk. Credit risk is the risk that the borrower will default on the mortgage. Interest rate risk is the risk that interest rates will either rise—in which case the interest rate the investor earns on the mortgage will be below market—or that interest rates will fall—in which case the mortgage will now be at an above market rate, but with the borrower likely to refinance.

GSE and Ginnie Mae securitization (“Agency MBS”) divides the credit risk from the interest rate risk. Investors in Agency MBS assume interest rate risk, but not credit risk. The credit risk is retained by Fannie, Freddie, or Ginnie, which often are insured for part or all of that risk, either through private mortgage insurers or through FHA insurance and VA guarantees.

In contrast, investors in private-label MBS assume both interest rate risk *and* credit risk. Yet in the past few MBS investors truly thought they were assuming more than *de minimis* credit risk: over 90% of private-label MBS were rated AAA at issuance by credit rating agencies. Investors who relied on these ratings understood the credit risk on these PLS to be negligible because of the quality of the underlying mortgages and various credit enhancements to the PLS, such as senior-subordinate credit structures, overcollateralization, excess spread accounts, and various types of insurance.

What this means is that the overwhelming majority of investors in the U.S. secondary mortgage market are not credit risk investors. Investors in Agency MBS are not credit risk investors, and most investors in PLS did not perceive themselves as assuming credit risk. Instead, most investors in the U.S. mortgage market are interest rate risk investors. There is approximately \$6 trillion in interest-rate-risk-only investment in the US mortgage market.

Interest rate risk investors are very different types of investors than credit risk investors. Investing in credit risk successfully requires a different kind of diligence and expertise than interest rate risk investment. A large portion of the investment in U.S. mortgages is from foreign investors.<sup>23</sup> Chinese investment funds and Norwegian pension plans, for example, are unlikely to seek to assume credit risk on mortgages in a consumer credit market they do not know intimately. But interest rate risk is something that foreign investors are far better positioned to assume because it is highly correlated with expectations about U.S. Federal Reserve discount rates.

The PATH Act’s elimination of the government guarantee (other than for a scaled-down FHA/Ginnie Mae) means that all credit risk on MBS would be borne by investors. There is no evidence that there is a substantial body of capital eager to assume credit risk on U.S. mortgages *at any interest rate*, much less at mortgage rates that would not be prohibitively expensive for borrowers. Even if private-label MBS were structured to remove most credit risk from some securities (thereby concentrating it in others), few investors are likely to trust credit ratings on MBS in the foreseeable future. The only way the Utility would get around this is through an implicit guarantee, which is the worst of all worlds.

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<sup>23</sup> Ben S. Bernanke et al., *International Capital Flows and Returns to Safe Assets in the United States, 2003-2007*, Board of Governors of the Federal Reserve System International Finance Discussion Papers Number 1014, February 2011.

There is a frightening implication to this: the privatization of the secondary mortgage market could result in as much as \$6 trillion in housing finance investment leaving the U.S. housing finance market rather than assuming credit risk. Even if only a third of this investment left the US market, the result would be an economic collapse on a scale far worse than in 2008, as housing prices would plummet nationwide. The PATH Act is gambling with the American economy based on ideological preferences, not evidence.

#### **V. THE JUMBO MARKET DOES NOT PROVIDE EVIDENCE OF THE VIABILITY OF A LARGE-SCALE PRIVATE MARKET**

Mortgages that are too large to qualify for purchase by the GSEs because of the statutory conforming loan limit are known as “jumbo” mortgages. There is a private securitization market in jumbo mortgages. In the jumbo market, investors assume both interest risk and credit risk. Advocates of privatization often claim that the existence of the jumbo market is proof that a securitization market can function without a government guarantee. This argument ignores the small size of the jumbo market and the numerous ways in which it piggybacks on the Agency market. In fact, the jumbo market in fact indicates that there is a quite limited demand of credit risk on U.S. mortgages, and certainly not enough to sustain the entire market absent a government guarantee.

The jumbo market overall is substantially smaller than the conforming market. The jumbo market overall is only perhaps 10-15% of all originations by either volume or dollar amount. In 2011, there were \$203 billion in jumbo originations, when the entire market was \$1.35 trillion in originations. This figure is roughly in keeping with pre-2008 ratios, and jumbos have never been more than a quarter of the total market.

What’s more, the securitization rate for jumbo loans is substantially lower, which has resulted in a much smaller amount of jumbo mortgage-backed securities issued than GSE MBS. Jumbos’ lower securitization rate is itself strong evidence of limited investor demand of credit risk on U.S. mortgages—at least at interest rates less than those borne on subprime loans.

The prime jumbo market does function without a government guarantee, but it also benefits from the existence of a government guarantee indirectly in multiple ways. For example, jumbo portfolio lenders hedge their interest rate risk by investing in GSE securities.<sup>24</sup> Advance rate lock-ins on jumbos are available because jumbo lenders can largely hedge their rate risk using the conforming TBA market. The jumbo market has also long aped the standards set by the GSEs in the conforming market, including amortization, maturity lengths, and appraisal standards. Finally, the jumbo market has benefitted from the stability in housing prices and overall systemic stability created by the government guarantee in the conforming market given the serial correlation of housing prices. Indeed, the virtual disappearance of the jumbo market following the financial collapse in 2008 draws into question whether this market is in fact viable; the spillover benefits from the guarantee in the conforming market have not been enough to resuscitate the jumbo market.

The jumbo market demonstrates that there are *some* investors who are willing to assume credit risk on U.S. mortgages. But investors in the vast majority of the \$6 trillion plus in U.S. mortgage securities outstanding are interest rate investors, and it is difficult to imagine them transforming into credit risk investors over several years, much less immediately. Sufficiently

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<sup>24</sup> Frank E. Nothaft, *Lessons from the Jumbo Market*, 1996 Mortgage Market Trends 12 (1996).

high yields would no doubt lure some of them into accepting credit risk—but that translates into much higher mortgage interest rates, which in turn increases the credit risk on the mortgages. And even higher yields will not be sufficient to induce investors who have no interest in assuming credit risk to buy into the U.S. mortgage market. The fundamental problem with any housing finance privatization proposal is that there just isn't sufficient capital interested in credit risk on U.S. mortgages. Ideology cannot substitute for market demand.

## **VI. THE PRIVATE-LABEL SECURITIZATION MARKET WILL NOT PRODUCE WIDELY AVAILABLE 30-YEAR FIXED RATE MORTGAGES**

Privatization advocates also claim that the presence of jumbo 30-year fixed rate mortgages (“FRMs”) demonstrates that a private market will continue to produce 30-year FRMs.<sup>25</sup> This is a strawman argument. No one claims that the 30-year FRM will entirely disappear with privatization. Instead, privatization will turn it into a niche product that is not widely available to American families.

The fully prepayable 30-year fixed-rate mortgage is a uniquely American and uniquely consumer friendly product that furthers economic stability and monetary policy. The 30-year FRM is the crown jewel of the American housing finance system. Its long amortization period lowers mandatory monthly payments. The fixed rate shields households from inflation and facilitates stable household budgeting. The ability to prepay enables consumers to take advantage of improved rate environments and to pay down the mortgage faster if they have excess funds. And the prepayment feature greatly facilitates Federal Reserve monetary policy by enabling lower interest rates to easily translate into greater disposable income for consumers and increased consumer spending in the real economy. 30-year FRMs underwritten with full documentation did not blow up in the housing bubble. Any restructuring of the system should start with the question of how to ensure the widespread availability of the 30-year FRM.

History indicates that the private market will not produce 30-year FRMs in any volume. Long-term fixed-rate mortgages were virtually unheard of in the United States prior to the federal government's entrance into the housing finance market during the New Deal. Instead, the pre-New Deal private market produced short-term “bullet loans”—non-amortized, interest-only 3-5 year FRMs that had to be frequently rolled-over before the “bullet payment” of the entire principal came due. If the borrower's credit quality declined, if interest rates had increased, or if the market was frozen, the borrower had to bite the bullet and come up with the cash to pay off the entire principal.

This sort of bullet loan structure is exactly what the private-label securitization market returned to during the bubble years: loans with short 2-5 year teaser rates, sometimes interest-only or even negatively amortizing, before a major rate reset. These loans were expected to be refinanced before the rate reset. We know the result.

Similarly, the fully private commercial mortgage market—which operates using both portfolio lending and securitization—rarely produces fully amortized 30-year FRMs. Instead, the standard commercial mortgage product is a 10-year interest-only loan. Prepayment penalties or yield-maintenance clauses are common, and it is rare to find fixed-rates for commercial loans

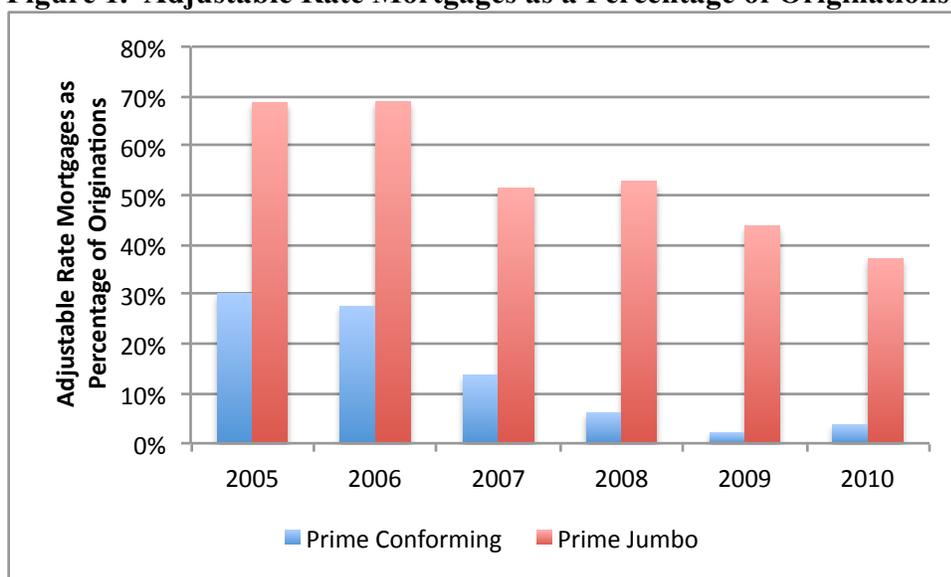
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<sup>25</sup> See, e.g., Testimony before the Senate Banking Committee, Peter Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute (Mar. 2013) (noting that there are Google results for the search “30-year jumbo fixed rate mortgage.”)

of periods beyond 10 years. Left to its own devices the private market eschews long-term fixed-rate loans.

The jumbo market does produce 30-year FRMs. But it only produces a very small number of them. Jumbos are only a small percentage of the market overall, and only a minority of jumbos are FRMs, and not all of those are 30-year maturities. Even in the extreme low-rate environment of 2009-2010, over a third of jumbos were adjustable rate mortgages (“ARMs”), compared with less than 5% of prime conforming loans. As Figure 1, below, shows, the jumbo market (Prime jumbos) contains a considerably higher percentage of ARMs than the GSE market (Prime Conforming). The private jumbo market simply does not produce very many 30-year FRMs. In fact, *in recent years jumbo FRMs have been only 4% of the entire mortgage market*.<sup>26</sup> 30-year jumbo FRMs may be advertised on websites, as privatization proponents have noted,<sup>26</sup> but in practice they are rare. The existence of a small number of FRMs in the relatively small jumbo market is not a basis for assuming that the market will produce 30-year FRMs on any scale absent a government guarantee.

**Figure 1. Adjustable Rate Mortgages as a Percentage of Originations<sup>27</sup>**



## **VII. THE PATH ACT WILL MAKE IT IMPOSSIBLE FOR HOMEBUYERS TO LOCK IN RATES IN ADVANCE AND WILL RESULT IN GEOGRAPHICAL PRICE DISCRIMINATION**

One of the marvels of the US housing finance market is the ability of homebuyers to lock in rates as much as 90 days prior to closing. This is a feature that is unheard of elsewhere in world. The ability to lock in rates in advance is a considerable benefit to both buyers and sellers. It allows buyers to be pre-qualified for a mortgage and thus know in advance how much they are able to spend on a home purchase. This certainty allows sellers to maximize sale prices because prices do not need to be discounted for the uncertainty of financing rates. The result is to enhance the liquidity of the US housing market and boost housing prices accordingly.

<sup>26</sup> See Wallison, *supra* note 25.

<sup>27</sup> Emanuel Moench, James Vickery, & Diego Aragon, *Why Is the Market Share of Adjustable Rate Mortgages So Low?* 16 CURRENT ISSUES IN ECON. & FIN. 1, 3 (Fed. Reserve Bank of N.Y. 2010).

Homebuyers are able to lock in rates in advance because lenders are able to do so themselves by selling advanced commitments in the form of forward contracts on the “To-Be-Announced” (“TBA”) market. The TBA market is a market of forward contracts in MBS. The TBA market exists only for GSE MBS; jumbos and other private-label MBS do not trade in the TBA market.<sup>28</sup> Thus, to the extent that a borrower can lock in a jumbo rate in advance, the lender must assume the rate risk in this duration. Lenders are willing to do so in part because they can largely hedge the rate risk on the jumbo through offsetting sales in the TBA market.

The TBA market is able to function solely because the GSEs’ MBS are exempt from the registration requirements of the federal securities laws. Because the TBA market involves the sale of MBS *before the MBS have been created*, it is impossible for those MBS to be registered with the SEC.<sup>29</sup> Section 343 of the PATH Act would create an exemption from the registration requirements of the Securities Act of 1933 for “qualified securities” that are issued using the Common Securitization Platform.

Despite the Securities Act exemption, the PATH Act is still likely to destroy the TBA market by destroying the high degree of fungibility that exists between GSE MBS. There is variation among the GSE securities that trade in the TBA market, but they also all share three key features that help homogenize the GSE MBS: (1) all credit risk is held by the GSEs; (2) all are pass-through securities; and the (3) geographic composition of the pools cannot be determined by investors. The variations among GSE MBS that trade TBA are relatively minor.

None of these common features would exist for the “qualified securities” issued using the Common Securitization Platform, and there would be even less fungibility among the covered bonds that the PATH Act authorizes. Credit risk on “qualified securities” would be held by the MBS investors and would vary in part based on the financial strength of the issuer that makes the representations and warranties about the quality of the securitized mortgages. As a result, these securities are very likely to be structured for create credit enhancement, rather than pass-throughs. Structuring would destroy fungibility, as the credit enhancements would vary between individual MBS. And because investors would bear credit risk, they would demand to know information such as geographic composition of pools, as they already do for private-label MBS.

The result will be geographic price discrimination, with higher interest rates experienced in parts of the country that are perceived of as riskier, either in terms of credit risk or in terms of prepayment risk (such as states with greater population mobility). Almost assuredly, the result of the PATH Act would be that the South and West would face higher mortgage rates, just as they did before the entry of the federal government into the housing finance market. The PATH Act will undermine the TBA market and make it extremely difficult for borrowers to lock in mortgage rates 60-90 days before closing.

### **VIII. THE PATH ACT WOULD HAVE EXTREME RAMIFICATIONS FOR THE FEDERAL BALANCE SHEET AND WOULD RESULT IN THE GOVERNMENT BREACHING THE DEBT CEILING**

Currently the GSEs’ enormous books of assets and liabilities are not on the federal balance sheet, as they only have *de facto*, not *de jure* backing from the federal government.

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<sup>28</sup> So-called “conforming jumbos” or “high balance” conforming loans have traded in the TBA market since 2008, after the conforming loan limits were temporarily raised under the Economic Stimulus Act of 2008, but these loans are guaranteed by the GSEs and should not be confused with traditional Jumbos.

<sup>29</sup> 12 U.S.C. § 1455(g) (Freddie Mac exemption); 12 U.S.C. 1717(c) (Fannie Mae exemption).

Accordingly, the GSEs' liabilities are not permitted to appear on the federal balance sheet.<sup>30</sup> The PATH Act, however, pledges the full faith and credit of the United States to repay the GSE's debt securities, MBS, and other financial obligations.<sup>31</sup> The effect of doing so would be to put all of those outstanding GSE obligations on the federal balance sheet. The PATH Act will cause \$6.1 trillion in debt to appear on the federal balance sheet.<sup>32</sup> While the federal debt ceiling was raised in May 2013 to \$16.699 trillion, placing the GSEs' outstanding obligations on the federal balance sheet will cause the government to breach the debt ceiling.<sup>33</sup>

## **IX. THE PATH ACT ENCOURAGES TOO-BIG-TO-FAIL VIA COVERED BOND PROGRAMS**

The PATH Act seeks to supplement private-label securitization through broader authorization of covered bonds. Covered bonds are simply bonds secured by a "cover pool" of mortgages. The cover pool is over-collateralized relative to the principal due on the bonds and must be periodically refreshed if it becomes insufficiently collateralized. If the cover pool proves inadequate, the covered bondholders have recourse to the other assets of the issuer, typically a bank. Covered bond programs are used widely in Europe for housing finance.

The key problem with covered bond programs is that they reinforce the too-big-to-fail problem that plagues the US financial services industry. (Covered bonds also reduce assets available to satisfy the FDIC's claims in a receivership.) Covered bonds basically recreate Fannie Mae and Freddie Mac. Investors in covered bonds assume the rate risk on the bonds, but the credit risk on the covered bond issuers, just like Fannie/Freddie MBS investors. This risk allocation structure has two implications.

First, it means that covered bond issuers are likely to be bailed out by the federal government. This is because the failure of one covered bond issuer could set off a panic throughout covered bond markets, much as we saw with the SIVs in the summer of 2007 and with thrifts in the summer-fall of 2008. To be sure, the PATH Act provides for the separation of cover pools from failed covered bond issuers, but investors are still likely to incur losses in those separated cover pools.

In fact, in 2008-2009, covered bond issuers were bailed out in the world's largest covered bond market, Germany. Germany provided support to three large covered bond issuers "leading to perceptions that the German authorities are prepared to offer systemic support to the *Pfandbrief* [covered bond] bank."<sup>34</sup> Germany was not prepared to allow even one of its covered bond issuers to fail, even though arguably no single issuer was a systemically important financial institution. As the International Monetary Fund has observed, "the relevance of *Pfandbrief*

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<sup>30</sup> 31 U.S.C. § 1501(a).

<sup>31</sup> PATH Act § 109 (29:22-30:2).

<sup>32</sup> Indeed, even if the provision were only to go into effect five years after the effective date of the PATH Act (it is not currently so drafted), it would still have a large effect on the federal balance sheet.

<sup>33</sup> Similarly, the PATH Act's deficit reduction provision is entirely illusory. Section 110 proposes that after five years all GSE guarantee fee revenue would be diverted to Treasury with an earmark for deficit reduction. Section 110, however, would also end all new GSE business within five years. If the GSEs are not doing any new business, there would not be any guarantee fee revenue to divert to Treasury. The PATH Act's deficit reduction is entirely illusory.

<sup>34</sup> International Monetary Fund, *Germany: Technical Note on the Future of German Mortgage-Backed Covered Bond (Pfandbrief) and Securitization Markets*, IMF Country Report No. 11/369, Dec. 2011, at 30.

[covered bond] issuance for bank funding may make it difficult to resist call for the bailout of a distressed issuer if authorities are determined to keep this important market open.”<sup>35</sup>

Second, the risk allocation structure means that larger financial institutions will have a funding advantage for covered bonds because they are too-big-to-fail. Investors will perceive covered bonds issued by too-big-to-fail banks as implicitly guaranteed by the government, just as they viewed Fannie/Freddie securities. Larger covered bond issuers are more likely to be bailed out than smaller ones. Unless one truly believes that the Dodd-Frank Act ended bailouts, then covered bonds will merely recreate Fannie and Freddie in the guise of the nation’s largest banks. Covered bond issuance on any scale reinforces too-big-to-fail.

## **X. THE PATH ACT ENCOURAGES PREDATORY LENDING**

Some of the most concerning provisions of the PATH Act are those that repeal key anti-predatory laws.<sup>36</sup> The centerpiece of the federal anti-predatory lending provisions is the prohibition on the origination of mortgages without verification of the borrower’s ability to repay.<sup>37</sup> Relatedly, federal law also prohibits the payment of yield-spread premiums to mortgage brokers.<sup>38</sup> Yield-spread premiums were payments to brokers for steering borrowers into more expensive loans, and were paid by lenders out of the additional loan charges. The CFPB has already promulgated a widely-praised, balanced rulemaking<sup>39</sup> for the ability-to-repay requirement, known as the Qualified Mortgage or QM rulemaking.<sup>40</sup> The rulemaking is set to become effective on January 10, 2014. Section 406 of the PATH Act, however, would postpone its effective date under January 10, 2015, resulting in another year’s delay of the QM rule.

Section 410 of the PATH Act would eliminate *for all mortgages* the remedy provision for failure of verification of the borrower’s ability to repay and for the payment of a yield-spread premium on a broker.<sup>41</sup> It provides a recoupment or setoff defense to foreclosure in the event that the lender failed to verify the borrower’s income or paid a yield-spread premium. By deleting this remedy provision, the PATH Act renders the ability-to-repay requirement and yield-spread premium prohibitions toothless.<sup>42</sup>

PATH Act section 408 would exempt “qualified securities”—private-label MBS issued using the Utility—from the ability-to-repay requirement, while PATH Act section 409(b) would exempt all loans held in portfolio from the ability-to-repay requirement. Thus, only private-label securities not issued through the Utility would be subject to the ability-to-repay requirement, but for these loans the ability-to-repay requirement would have little import because PATH Act section 410 would eliminate the remedy provision for the ability-to-repay requirement. In short, no one would have to bother verifying borrower’s ability to repay under the PATH Act.

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<sup>35</sup> *Id.* at 5.

<sup>36</sup> Relatedly, section 107 of the PATH Act would restrict the GSEs to purchasing only “qualified mortgages,” as that term is defined under Consumer Financial Protection Bureau regulations. It is not clear what this provision is intended to accomplish, as the CFPB has defined QM to incorporate GSE underwriting standards. 12 C.F.R. § 1026.43(e)(4)(ii)(A)(1)-(2). The result is the legislative equivalent of an infinite loop.

<sup>37</sup> 15 U.S.C. § 1639c.

<sup>38</sup> 15 U.S.C. § 1639b(c).

<sup>39</sup> Rachel Witkowski, *CFPB Hits Home Run on Mortgage Rule Revisions*, AM. BANKER, May 30, 2013.

<sup>40</sup> 78 F.R. 6407-6620 (Jan. 30 2014), *codified at* 12 C.F.R. pt. 1026.

<sup>41</sup> PATH Act § 410 (repealing Dodd-Frank Act section 1413 (*codified at* 15 U.S.C. § 1640(k))).

<sup>42</sup> Arguably there could still be regulatory enforcement of the ability-to-repay requirement, but that will do little to help the individual homeowners who have been harmed.

PATH Act sections 409(b), 410, and 411 are similarly aimed at enabling predatory mortgage lending. The Home Owners Equity Protection Act (HOEPA) has long tagged certain high-cost mortgage loans for extra regulation because of a concern that these loans are likely to be predatory and taking advantage of the borrower's lack of sophistication or bargaining power. In addition to gutting the ability-to-repay requirement, PATH Act section 410 repeals Dodd-Frank Act's amendments to HOEPA. The expanded the definition of a HOEPA loan<sup>43</sup> and prohibited balloon payments on HOEPA loans.<sup>44</sup> The PATH Act would thus permit balloon payments on possibly predatory mortgage loans and narrow the definition of these HOEPA loans.

PATH Act section 409(b) would eliminate tax and insurance escrow requirements for high-cost loans for portfolio lenders. Mandatory escrow accounts for taxes and insurance are also required under the Dodd-Frank Act for high-cost loans.<sup>45</sup> This requirement is to protect homeowners from losing their home and their equity investment shortly after purchase because of failure to pay taxes or insurance. The CFPB currently has explicit regulatory authority to exempt portfolio lenders from the high-cost loan escrow requirement, but chose not to grant an exemption to portfolio lenders as part of its escrow requirement rulemaking.<sup>46</sup> The CFPB did grant an exemption to certain rural mortgage lenders.<sup>47</sup> Rather than defer to regulatory expertise, section 409(b) of the PATH Act would give a green light to predatory lenders failing to escrow for taxes and insurance, which often paves the way for foreclosure.

In a similar vein, PATH Act section 411 permits borrowers to waive the additional disclosures required for HOEPA loans. This is a particularly pernicious provision because the unsophisticated or desperate borrowers HOEPA seeks to protect are precisely the type who would be likely to waive its provisions. With provisions like sections 408, 409, 410, and 411, the PATH Act is encouraging a return of the predatory lending.

## **XI. THE PATH ACT BULLIES MUNICIPALITIES LOOKING FOR A SOLUTION TO THE FORECLOSURE CRISIS**

The PATH Act includes a pair of provisions, sections 108 and 226, that would prohibit the GSEs or FHA respectively from purchasing or insuring mortgages in municipalities that had exercised their legal eminent domain power to seize a mortgage in exchange for its fair value for a public purpose within the previous five years. These provisions are in response to the proposal considered, but not adopted by several municipalities, to use eminent domain to seize and restructure distressed mortgages. The thinking behind the eminent domain proposals is that by forcing such a restructuring, the municipalities may be able to prevent unnecessary foreclosures and bypass incompetent and conflicted mortgage servicers and avoid the serious externalities that foreclosures impose on neighboring homeowners, on tax bases, and on communities.

The wisdom and ultimate economic feasibility of eminent domain proposals are debatable. Yet two things are clear. First, the use of eminent domain in this context is hardly "constitutionally-suspect" as has been alleged. There are well-established Supreme Court precedents that indicate that eminent domain proposals would neither violate the 5<sup>th</sup> Amendment

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<sup>43</sup> 15 U.S.C. §§ 1602(aa)(1), 1602(dd) (Dodd-Frank Act § 1431).

<sup>44</sup> 15 U.S.C. § 1639(e) (Dodd-Frank Act § 1432).

<sup>45</sup> 15 U.S.C. § 1639d.

<sup>46</sup> 15 U.S.C. § 1639d(c)(3); 78 F.R. 4725-4757, *codified at* 12 C.F.R. pt. 1026.

<sup>47</sup> 78 F.R. 4725-4757, *codified at* 12 C.F.R. pt. 1026.

Takings Clause or the Contracts Clause.<sup>48</sup> No serious legal analyst would conclude that eminent domain proposal is on anything but solid legal ground. In any case, Congressional action is unnecessary, as the courts will police the constitutionality of the proposals.

Second, as the PATH Act itself recognizes, there are serious problems in mortgage servicing, including conflicts of interest between mortgage servicers and mortgage investors. Section 414 of the PATH Act prohibits mortgage servicers from having an interest in junior liens on the properties on which they service the first mortgage. It is only reasonable for municipalities to seek a solution to this problem, as they bear some of its costs, and they have no tool other than eminent domain. There are better solutions to dealing with the foreclosure crisis than eminent domain, but Congress has repeatedly failed to pass legislation alleviating the foreclosure crisis, not least because of the concerted opposition of some of the sponsors of the PATH Act.

It is unreasonable to recognize the dilemma faced by municipalities with a provision like section 414, and then threaten them with provisions like PATH Act sections 108 and 226 when the municipalities try to use the only tool they have for dealing with the foreclosure crisis. It may also be unconstitutional by depriving the municipalities of their 10<sup>th</sup> amendment rights.<sup>49</sup> PATH Act sections 108 and 226 are a distraction from the serious work of GSE reform.

## **XII. THE PATH ACT WOULD RECREATE MERS AND ENGAGE IN A RADICAL PRIVATIZATION LAND RECORDS**

The PATH Act would create a National Mortgage Data Repository—a privately owned and operated national recorder of deeds office. The concept behind the Repository is at once radical, pernicious, and unconstitutional.

Since 2007 there have been thousands of court cases contesting foreclosures on the basis of mortgage lenders' inability to prove that they have standing to foreclose.<sup>50</sup> These cases are ultimately about conflicting and competing laws governing the transfer and enforcement of notes and security instruments. Much of the confusion is the mortgage industry's own fault. The mortgage industry muddied the law on the transfer and enforcement of mortgages and was less than punctilious in its paperwork practices. To wit, the mortgage industry created a private mortgage registry, known as the Mortgage Electronic Registration System (MERS), in order to avoid paying local mortgage recording taxes. Unfortunately, MERS is often a poor fit with state law and the MERS database is replete with inaccuracies.<sup>51</sup> Moreover, the mortgage industry pushed through changes in Article 9 of the Uniform Commercial Code that have created confusion as to what is required to transfer and enforce mortgage notes. Compliance with Article 9's provisions cannot be proven for many securitization deals.

These are problems that are getting worked through in the courts and state legislatures. They are not always being resolved the way the mortgage industry likes, however, so now with

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<sup>48</sup> See, e.g., *Kelo v. City of New London*, 545 U.S. 469 (2005); *Home Building & Loan Association v. Blaisdell*, 290 U.S. 398 (1934).

<sup>49</sup> There may also be privileges and immunities clause problems with the provision penalizing innocent residents who moved to municipalities in the five years after the eminent domain was exercised.

<sup>50</sup> See Adam J. Levitin, *The Paper Chase: Securitization, Foreclosure, and the Uncertainty of Mortgage Title*, 63 DUKE L.J. (forthcoming 2013).

<sup>51</sup> I served as a Volunteer Deputy Attorney General for the State of Delaware for a suit against MERS for violating Delaware's unfair trade practices statute. The suit resulted in a settlement.

the PATH Act we see an attempt to solve the problem by creating a new federally-authorized MERS in the form of the proposed Repository.

There are several problems with the Repository. First and foremost is the motivation for its creation. There is a reasonable case to be made for having solely federal regulation of mortgage finance. That would be a rational way to design the system from scratch (although it may not work within the Constitution).<sup>52</sup> But that is not what is motivating the PATH Act's proposal for a Repository. Instead, the sole purpose of the proposal is to help mortgage lenders avoid dealing with pesky things like state law rules of evidence. Thus, PATH Act section 332 provides that a "proper demonstration of registration with the Repository" is sufficient to satisfy various state law evidentiary requirements for prosecuting foreclosures. In other words, mortgage lenders are exempt from the state law evidentiary rules. This is the wrong reason to create a federal mortgage registry.

The second problem with the Repository proposal is that it would functionally prohibit county level land recordation or render it of limited value. Section 316(b) of the PATH Act bans other private mortgage registries and also bans state registries to the extent they conflict with Repository. The effect is necessarily to put county land registries out of business. In roughly half the states (so-called "title theory" states) a mortgage is considered a sale of a property. Accordingly, mortgages and mortgage assignments need to be recorded in county land records for chains of property title to be clear. It is hard to see how these states could continue recording deeds to property without running afoul of section 316(b) of the PATH Act. In the other half of the states (so-called "lien theory" states) a mortgage is considered merely a security interest, but even so the Repository's separation of mortgage recordation from land title recordation makes it impossible to determine who has clear title to real property from the county land records.

The effect, then, of the PATH Act, would be to privatize what has long been a core governmental function, namely the maintenance of title to real property. This is an unprecedented and ill-advised step and a third problem with the PATH Act Repository. We do not have records to vehicles, boats, airplanes, patents, trademarks, or even household goods operated privately. We trust government and only government as an honest steward of these records. We do have regulated private registries for securities—especially the Depository Trust Company (DTC)—but a system that works for sophisticated investors against the backdrop of uniform law is not the type of system that should be adopted for dealing with rights in people's homes that vary based on state. What's more, the PATH Act would exculpate the Repository from private liability for mistakes, meaning that there would be no meaningful relief for homeowners who were harmed because of the negligence of a private party.<sup>53</sup> If we have learned anything from the experience with MERS it is that private parties should not be trusted to run mortgage registries.

A fourth problem with the Repository relates to its treatment of state and local real estate recording taxes and fees. It is also unclear whether transfers of mortgages in the Repository would be subject to state and local real estate recording fees and taxes. If so, the benefits of the Repository are quite small: the Repository's only purpose would be to exempt mortgage lenders

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<sup>52</sup> A federal mortgage registry should be operated by a government entity (probably housed within the CFPB), and would need to address the local to federal revenue transfer.

<sup>53</sup> PATH Act § 334.

from state law rules of evidence for proving debts. There is no reason that mortgage lenders should not have to follow the law like all other creditors.

If transfers of mortgages in the Repository are not subject to local, however, the creation of the Repository would represent an enormous expropriation of local government revenue for the benefit of a privately-owned Repository (which would charge its own fees). Local governments around the country depend on revenue from real estate recording fees and taxes.

Finally, the creation of a federally-authorized mortgage Repository may in fact not be Constitutional, as it arrogates to the federal government a traditional state function that is arguably among the rights reserved to the states under the 10<sup>th</sup> Amendment. The PATH Act Repository is the wrong solution to a mess of the mortgage industry's own creation.

### **XIII. MOVES IN THE RIGHT DIRECTION**

The PATH Act is the wrong blueprint for reforming the housing finance market. It does, however, get a few critical things right and these features should be incorporated in any reform of the housing finance system.

First, the PATH Act recognizes the importance of standardization in MBS and attempts to encourage it. Greater standardization of MBS—from loan underwriting and documentation to aggregation and securitization practices and documentation to securitization structures—should be a major goal of any housing finance reform bill, as standardization will make the housing finance market more liquid and also facilitate investor diligence.<sup>54</sup> The PATH Act's Utility would create standardized MBS,<sup>55</sup> but unfortunately they would have to compete with non-standard private-label MBS.

Second, the PATH Act creates only a single government-sponsored securitization platform. While I disagree with the powers and structure of this platform, the PATH Act is correct to have a single platform, rather than multiple competing platforms. The existence of multiple competing platforms could easily result in a race to the bottom in credit standards as platforms compete for market share. Indeed, this is a very possible outcome of the Dodd-Frank Act's mandate for derivatives to clear through clearinghouses.<sup>56</sup>

Third, title III of the PATH Act recognizes the need for improvements in servicing standards and trustee standards and rightly defers to provisions of the Trust Indenture Act of 1939. Section 414 of the PATH Act, prohibiting servicers of first liens from having an ownership stake in second liens secured by the same properties, is a first step in dealing with servicer conflicts of interests, and section 322(d), (e), and (h) anticipate improved servicing and trusteeship standards. The servicer and trustee problems in structured finance are serious ones,

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<sup>54</sup> Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1252-58 (2012).

<sup>55</sup> PATH Act § 322(b).

<sup>56</sup> See Adam J. Levitin, *The Tenuous Case for Derivatives Clearinghouses*, 101 GEO. L.J. 445 (2013). Contrary to popular belief, the current Fannie-Freddie system did not evolve because Congress believed there a need for competition to Fannie. It evolved in 1970 when Fannie was permitted to purchase conventional mortgages. Previously, Fannie had only dealt with FHA/VA mortgages, and its sellers were primarily mortgage banks. The conventional market was dominated by savings and loans, which feared that Fannie would be too solicitous to the mortgage banks, so the S&Ls demanded their own secondary market utility. In short, there is not a competition story, but a political interest group story. See Adam J. Levitin & Susan M. Wachter, *The Public Option in Housing Finance*, 46 U.C. DAVIS L. REV. 1111, 1160 (2013).

and I appreciate that the PATH Act attempts to address them. The steps proposed by the PATH Act may themselves be insufficient to deal with the problem that securitization trustees get their business from issuers who are affiliate with servicers, not from investors and therefore are not incentivized to vigorously police issuers or servicers, lest they bite the hand that feeds them. I would urge the Committee to pursue investors' servicer-trustee problem further.

Finally, and relatedly, the PATH Act recognizes the problem of “silent seconds,” namely the subsequent creation of junior liens on a property without the knowledge of the first lienholder. The creation of a junior lien negatively affects the first lienholder by making the borrower riskier. I am pleased that the PATH Act recognizes this problem and attempts to address it via section 413, which requires the servicers of junior liens to inform the servicers of senior liens of the existence of the junior liens. Unfortunately, the Section 413 does not solve the problem as it has no timing requirement for the notice and no enforcement provision or remedy for failure to notify.

Prior to the enactment of the Garn-St. Germain Act in 1982, “due on sale” clauses in mortgages would often make the encumbering of a property with a junior liens an event of default, allowing the first lienholder to accelerate the loan and demand immediate repayment. The Garn-St. Germain Act prohibited due on sale provisions triggered by the creation of junior liens.<sup>57</sup> The result was that first mortgage lenders lost control of the combined loan-to-value ratio on the property. This proved disastrous during the housing bubble. Notably, Texas avoided the worst of the bubble despite having a large population of subprime borrowers because state law severely restricted junior mortgages.<sup>58</sup>

The inability of first lien lenders to control the total LTV on a property is a major problem, and one solution that Congress should consider is repealing the Garn-St. Germain provision to enable senior lienholders to protect themselves from subsequent over-leveraging of collateral properties. Section 413 will not solve the silent seconds problem, but is a step in the right direction.

## CONCLUSION

The PATH Act is the wrong path for reforming our housing finance system. The PATH Act encourages the worst practices of the housing bubble: predatory lending, unregulated private-label securitization, and MERS. The PATH Act is a reckless gamble with the American economy based on a naïve faith in private markets that have repeatedly failed in the past.

We need to acknowledge that the importance of housing finance to the economy and social stability means that no government will ever let the market collapse. There will be a guarantee one way or another, explicit or implicit. The housing finance market needs to be reformed. But rather than flirting with an unrealistic and dangerous privatization of the housing finance market, there needs to be a serious and sober consideration of how best to structure and price the government guarantee of the housing finance system while ensuring the widespread availability of the long-term, fully-prepayable, fully-amortized, fixed-rate mortgage.

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<sup>57</sup> 12 U.S.C. § 1701j-3(d)(1).

<sup>58</sup> Texas Constitution, art. XVI, § 50(a).