Statement before the House Financial Services Committee
Subcommittee on Capital Markets and Government Sponsored Enterprises
On the Private Mortgage Market Investment Act

Why and How to Revive the Private Securitization of Mortgages

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Chairman Garrett and Ranking Member Waters. Members of the Committee. I appreciate the opportunity to testify before this subcommittee today on ways to revive the private securitization market.

This is an important subject for several reasons that go well beyond housing. First, the United States is in the midst of a major effort to cut its national debt, which is already close to $14 trillion; according to the Congressional Budget Office, the debt will reach $23 trillion in 2021 if current policies continue. One component of that debt—off-budget and not included in the $23 trillion figure—are the obligations of the government-sponsored enterprises Fannie Mae and Freddie Mac.

Too many people around Washington, and too many self-interested parties, want to put the government and the taxpayers needlessly on the hook for yet more debt in support of the housing system. As a result of the high loan limits and the suppression of private securitization through the obstacles and disincentives listed below, approximately 90% of all originations and 99% of all securitizations are now government guaranteed. This is an ongoing liability for the taxpayers and an unhealthy fiscal position for the United States.

Further, creating more government-backed paper to finance the housing market turns out to be yet another way to assess the taxpayers. Government-backed mortgage paper competes with Treasury securities of equal maturity, and thus raises the interest rate that the Treasury has to pay on its own debt—another cost borne by the taxpayers. It's difficult to be exact about how much this might be, but a recent Fed study concluded that the Fed's purchase of mortgage-backed securities (MBS) issued by the government-sponsored enterprises (GSEs) lowered the cost of the Treasury's 10 year note by 30 to 100 basis points by taking the GSEs' competitive paper off the market. If this is accurate, the savings for the government and the taxpayers of going to a fully private housing finance market would amount to billions of dollars.

Instead of adding to the debt, we should be looking for ways to reduce the government's obligations. One of the ways to do that is to reduce the government's role in the housing market by turning as much as possible over to the private sector. This should not be considered a radical idea. The private sector finances virtually everything else in the US economy, and why it should do special favors for the housing industry in particular has never been apparent. After the financial crisis of 2008, which was brought about by the government's housing policy, it is remarkable that we are still wrestling with the question of whether and how to get the government out of this business.

In addition, private institutional investors—insurance companies and pension funds among them—badly need mortgages and mortgage-backed securities for investment. They are not major investors in GSEs securities—about $1.8 trillion out of total investments of $13 trillion—because the yields are too low. Instead, they are investing in corporate securities—even junk bonds—in order to obtain the yields they would get from good quality mortgages and MBS. These instruments would be liquid, high quality and relatively long term investments that would enable these long-term investors to diversify their holdings. They would be healthier and safer, and America's homeowners would have an immense and steady source of capital for their mortgage needs. This is a win-win for this country if ever there was one.

Finally, there could not be a better introduction to the need for the legislation this committee will consider today than a recent statement by former Fed chair Paul Volcker:[1]

> There is one very large part of American capital markets calling for massive structural change that so far has not been touched by legislation. The mortgage market in the United States is dominated by a few government agencies or quasi-government organizations. The financial breakdown was in fact triggered by extremely lax, government –tolerated underwriting standards, an important ingredient in the housing bubble. The need for reform is self-evident and the direction of change is clear. We simply should not countenance a residential mortgage market, the largest part of our capital market, dominated by so-called Government-Sponsored Enterprises.
>
> The residential mortgage market today remains almost completely dependent on government support. It will be a matter of years before a healthy, privately supported market can be developed. But it is important that planning proceed now on the assumption that Government-Sponsored Enterprises will no longer be a part of the structure of the market.

Planning now for the time when government-sponsored enterprises are no longer part of the structure of the housing market is precisely what this committee is doing today.

Reviving a Private Securitization Market

Reviving the private securitization system is necessary to finance large sectors of the housing market that are not served today, and would not be served in the future, by any government-backed system. There are not enough lendable funds in the banking sector to finance all the mortgages in the US, so we must rely on a supplementary system. Securitization of prime mortgages in the past has shown itself to be an efficient way to increase the funds available to the housing market. Other nongovernmental options, such as covered bonds, are available, but private securitization is a proven way to expand investment in home ownership.

Reviving the private housing finance system will be a daunting task, with many moving parts. Two things must be done in tandem. First, the GSEs must gradually be withdrawn from the market. The private sector cannot restart if they have to compete with—or believe they will have to compete with--government-backed entities. At the same time, changes must be made in existing laws and regulations that will encourage the entry of private sector securitizers and stimulate the interest of investors. Right now, in addition to the existence of the GSEs, there are a large number of impediments and disincentives that are keeping private firms from entering the

[1] Paul A. Volcker, The William Taylor Memorial Lecture, September 23, 2011, p11.

securitization market. If these are removed, I believe that private organizations will eagerly enter the field.

In this testimony, I will outline the necessary steps revive the private securitization market. Following that discussion, I will review the terms of the legislation introduced recently by Chairman Garrett.

I. Reducing the Costs and Increasing the Incentives of Securitizers

When a bank or other originator has made or acquired a mortgage loan, it has a number of alternatives. It can combine the loan with others, create a pool of loans, and sell them to investors in securitized form; it can insure the loan with the Federal Housing Administration (FHA) and create a Ginnie Mae security, sell it to Fannie or Freddie for a GSE pool, or finance it with deposits or with a loan from one of the Federal Home Loan Banks.

Each of these options entails a combination of risks and rewards, so if we want to encourage banks and others to assemble and sell private mortgage backed securities it is necessary to make that option advantageous in relation to the government agency options. To do that means creating financial incentives for securitization as well as removing risks and other disincentives. Outlined below are several items in current law or existing or proposed regulations that would tend to discourage originators from securitizing their mortgages, and thus to discourage the revival of private sector securitization in general.

Many of the disincentives below were created by the Dodd-Frank Act (DFA) itself, or the by regulations proposed thus far under the DFA. Thus, it should not be surprising that the private securitization market has not revived since the financial crisis of 2008. The DFA, enacted in the wake of the financial crisis, has done much to suppress and discourage the development of a private securitization market.

1. High GSE and FHA conforming loan limits. Currently, as directed by the Housing and Economic Recovery Act of 2008, the GSE loan limits have been reduced to $625,500, and FHA's limit to an equivalent level. These very high limits reduce the number of mortgages that are available for private securitization. One of the most important ways that Congress can revive a private securitization market would be to continue the trend, begun on October 1, to reduce the conforming loans limits of the GSEs and FHA. This can be done in stages, perhaps over five years, but it must be embodied in a law, so that private securitizers will have confidence that if they make the necessary investments there will be a large enough private market to make their investment worthwhile.

In addition, one of the reasons that the GSEs are able to outcompete private securitization is the fact that they have not in the past received compensation for the risks they were taking. Since their insolvency in 2008, it has become apparent that these risks were there, but well hidden. As the obstacles to private securitization are removed, FHFA should maintain guarantee fees and loan level risk adjustments that fully compensate the GSEs—and the taxpayers who own them—for their risks.

2. Risk-retention and capital. The provisions of the DFA that mandate a 5 % risk-retention for mortgage securitizers were originally intended to work in tandem with a requirement for a good quality mortgage, which was called the Qualified Residential Mortgage or QRM. The QRM was supposed to be a prime mortgage—not necessarily a bullet-proof mortgage—and the 5% risk-retention was supposed to be a penalty for not securitizing prime mortgages. That idea was lost as the regulations were developed, and the most recent proposed regulations—which mandated a 20 percent downpayment as part of a QRM—have been uniformly panned by the industry.

Minimum standards for mortgage quality make sense, but the risk-retention idea does not. As proposed, it would not prevent the origination of subprime or other low quality mortgages, and it would entail considerable capital costs for securitizers of mortgages that did not meet the very high QRM standard that the regulators proposed. Indeed, only the largest banks would have balance sheets large enough to retain these 5% slices over the many years required by the regulation. The prospect of incurring these capital costs is one of the items that is discouraging potential securitizers. It creates a strong incentive to sell loans to the GSEs or FHA rather than securitize them. As outlined below, a version of the QRM—that is, a minimum standard for securitized mortgages—should be retained, but the 5% retention requirement should be repealed.

3. FHA and GSE exemption from risk-retention. The DFA exempts FHA from the 5% risk-retention, and the initial proposed regulations under the DFA would also exempt Fannie and Freddie. As a result, each of these agencies will be able to securitize mortgages—even prime mortgages that do not meet the narrow QRM standard initially proposed by the regulators—at lower cost than any private firm. Accordingly, it would be extremely difficult for private firms to enter the securitization field while this provision exists, and few will be willing to do so. If it wants to stimulate the return of private securitization, Congress should repeal the 5% risk-retention. Its existence creates competitive advantages for Fannie, Freddie and FHA vis-à-vis private securitizers that present a virtually insuperable obstacle to the revival of a robust private securitization market.

4. **Risk-retention and true sale**. Another reason to repeal risk-retention is that it jeopardizes the ability of securitizers to get true sale (and thus off-balance sheet) treatment for securitizations under existing accounting rules. True sale treatment is available if the securitizer has transferred all liability. The proposed regulation offers four options, but only the vertical slice clearly qualifies for sale treatment, because the 5% retained in that case matches the risk profile of the pool. However, the vertical option does not represent a significant risk, and thus will not create a disincentive to making subprime loans. Accordingly, the one risk-retention method that qualifies for true sale treatment vitiates the intended purpose of the 5% risk-retention idea. For this reason alone, risk-retention should be repealed. As discussed below, mortgage quality would then be maintained by a regulation that specifies the requirements for one or more categories of prime loans.

5. T**he FDIC's safe harbor**. The FDIC's safe harbor regulation adds new provisions and conditions for determining whether a bank has properly divested itself of a pool of mortgages in a securitization. If so, the FDIC waives its right as receiver of a failed bank to reclaim the mortgages from the securitization. But the rule is immensely complex, and involves meeting some ambiguous quality standards. Whether these complex requirements will comply with the accounting rules, and whether the FDIC will agree that various quality requirements have been met, are open questions that substantially increase the risks of a securitization transaction. Under these circumstances, few banks will proceed with a securitization. This impediment to securitization can be eliminated by requiring the modification of the FDIC's rule so that the risk that the FDIC will intervene in a securitization to reclaim assets is effectively eliminated.

6. SEC's Regulation AB. This proposed regulation is intended to implement section 621 of the Dodd-Frank Act, which prohibits, among other things, securitization sponsors from engaging in transactions that involve a conflict of interest with investors in the securitization. If such a conflict of interest exists—and in theory it always exists between a buyer and a seller—the transaction can be rescinded. Therefore, before a bank or other issuer can engage in a securitization, it has to know that it will be complying with the DFA and proposed Regulation AB. Until the regulation is finalized, it will be very difficult for a securitizer to know whether it is complying with the DFA, and afterward it may not be possible for certain kinds of securitizations to be done. Accordingly, potential securitizers may not be willing to invest in the necessary resources to engage in this business, or will simply sell their loans to the GSEs, until there is certainty in this area. Legislation should make clear what specific transactions were meant to be covered, or the section 621 of the DFA should be repealed.

7**. Premium cash recapture**. The proposed regulations on premium cash recapture under the DFA also discourage securitization by substantially reducing the economic returns to securitizers. In some subprime securitizations a substantial spread between what the borrower paid and what the investor received was built into the transaction. There was concern that this spread was then used to compensate originators for delivering loans with higher interest rates than the borrower might have qualified for. To prevent this, the regulators seeking to implement the DFA's provision required the entire spread to be retained until all proceeds have been paid to the investors. In this position, it amounts to a risk-retention of some size and may jeopardize the availability of true sale accounting treatment. Although intended to address predatory lending, this provision would prevent securitizers from realizing the economic benefits of the spread even when they are securitizing prime mortgages. If they tried to make up this loss with a higher interest rate, they would be even less competitive with the GSEs. This provision should be modified so that it doesn't apply to prime mortgage securitizations.

8. Volcker Rule. Although justified as preventing the use of insured deposits for risky trading, this rule, enacted in the DFA, prohibits "bank related entities" from engaging in proprietary trading and thus extends far beyond the insured banks it was intended to cover. The term "bank related entities" includes bank holding companies and their subsidiaries, which do not have access to insured deposits. In addition, "proprietary trading" is so difficult to define that the most recent draft regulation covers almost 200 pages and poses over 1000 separate questions to assist the regulators in drafting the final rule. Hedging is a regular and important element of every securitization because it is necessary to protect the issuer against a change in interest rates between the time a mortgage rate is "locked in" with the borrower and the time a complete pool can be assembled for a securitization. Hedging transactions involve buying and selling of securities for the issuer's own account, and could be interpreted to be proprietary trading. Until there is a bright line definition of proprietary trading, it is unlikely that many banks or bank-related entities will take the risk of engaging in a securitization. It is unlikely that the complexity associated with proprietary trading can be adequately defined in a statute, and it may not be possible to define it clearly enough in a regulation. Accordingly, the Volcker Rule may stand permanently as a serious obstacle to private securitization. There are two ways to solve this problem: repeal the Volcker Rule, or apply it solely to insured banks and not the broader "bank-related entities." This will enable bank holding companies and their affiliates to engage in securitization without fear of violating the highly technical Volcker Rule when the regulation is ultimately finalized.

9. Qualified mortgage. The DFA also contains a concept called a Qualified Mortgage (QM), which is defined roughly as a mortgage that a borrower can afford. There are a number of severe consequences for providing mortgage credit to a borrower who could not afford to meet the obligations on the loan, the most significant of which is that a violation of the QM requirements can serve as a defense to foreclosure. This penalty extends to the investor as well as the securitizer, and could be mitigated if there were an effective safe harbor in either the DFA or the proposed regulation, but there is not. Without a clear and unambiguous safe harbor, this provision is a strong disincentive for anyone to securitize or acquire a mortgage.

10. Basel 3. Mortgage servicing rights (MSRs) are an important part of the securitization process, and an important part of the compensation that securitizers receive. Current accounting rules require that MSRs be capitalized and amortized over time. The new Basel rules on bank capitalization place a limit of 10 percent on the use of MSRs in computing tier 1 capital. This substantially reduces the value of MSRs to any financial institution covered by the Basel requirements. It also creates a number of other difficulties, the most important of which is an incentive on the part of any bank originator to sell its mortgages to the GSEs or FHA with servicing released. This problem will be difficult to address, because neither the accounting rules nor Basel 3 are easily changed. However, the loss of value of MSRs for capital purposes may not be an obstacle to securitization if the other impediments and disincentives listed above are removed. Banks that are bound by Basel 3 may be able to sell the MSRs separately or make up the regulatory capital cost another way.

II. Facilitating a Robust Private Securitization Market

Even if all the obstacles and disincentives listed above are eliminated, the private securitization market could be substantially improved and made more efficient.

1. Prime mortgage definition. Instead of a 5% risk-retention, which as defined in the proposed regulation will be ineffective in preventing the future growth of another subprime market, Congress should authorize the Federal Housing Finance Agency (FHFA) to recommend one or more mortgage formats or categories that would be considered prime mortgages. These mortgages, which would have a mixture of minimum downpayments, credit scores, debt-to-income ratios, loan terms and loan purposes—and could include mortgage insurance as additional credit enhancement—would be the only mortgages eligible for securitization. This would allow securitizers of all sizes—not just those that have balance sheets sufficiently large to carry the 5% retention—to engage in securitization of prime mortgages. It would also lower the cost of securitization. In order to stimulate the development of a To Be Announced (TBA) market over time, the number of such prime categories should be kept small enough to create the liquid private securities market that would permit TBA-based hedging.

2. Securities law exemption. In order to facilitate the growth of a TBA market in privately issued securities, the SEC should specify the disclosures that will be required in prospectuses and other selling documents and make them eligible for "shelf" registration.

3. Uniform securitization agreements. Just as Fannie and Freddie helped to create a more liquid secondary mortgage market by requiring a standard form of mortgage, FHFA should be directed to create standard forms for securitization documentation, including representations and warranties; mandatory arbitration of disagreements among issuers, servicers and investors; standardized servicer accounting; standardized reporting to investors on modification or workout of loans; and provisions for the appointment of a special trustee for investors where the servicer has a conflict of interest with investors.

III. Reducing Costs and Eliminating Impediments for Institutional Investors

Just as there are impediments and disincentives for banks and others to engage in securitization, there are also costs, impediments and disincentives for institutional investors to purchase MBS. Any effort to revive a securitization market should entail the elimination of these difficulties. The private institutional investor market—consisting of insurance companies, pension funds and mutual funds—includes at least $13 trillion that could be invested in fixed income securities such as privately issued MBS. Since Fannie and Freddie came to dominate the secondary mortgage market—keeping many of the gains and reducing yields—private institutional investors have not been major buyers of MBS. Only $1.8 trillion was invested in GSE securities in 2010; the balance apparently goes to corporates, including lower quality securities that involve more risk but produce the higher yields that institutional investors need. Enabling institutional investors to invest in MBS would improve their diversification and stability, as well as increasing the available funding for the housing market.

1. The Qualified Mortgage. As noted above, the QM created by the DFA creates potential liabilities for securitizers by giving borrowers a defense against foreclosure. The same factor creates potential losses for investors in MBS backed by mortgages that are subject to the QM. Until there is a much clearer safe harbor in the regulations that implement the QM, it is unlikely that a broad-based institutional investor market (or indeed any investor market) for mortgages or MBS will develop.

2. Second Liens. Current law allows second liens to be placed on homes without the consent of the first lienor. The thinking behind the provision of the Garn-St Germain Act that permitted this interpretation was probably that the first lienor can always wipe out the second in the event of a default. However, the foreclosure process is very lengthy in many states, and the second lienor can only be wiped out in a foreclosure. Moreover, the second lienor has a right to consent to a modification or a short sale that might be used in lieu of foreclosure. This gives the second lienor considerable leverage for compensation from the holder of the first lien, and of course increases the potential loss on the mortgage.

In addition, the holders of second liens frequently turn out to be the servicers on mortgages in MBS pools, and they sometimes delay or refuse foreclosure. The Garrett bill has a provision on servicer conflicts of interest that should solve this problem, but would not cure the problem of the second lienor refusing to consent to modification or a short sale without some consideration.

Accordingly, the law should be amended to require the approval of the first lienor before a subsequent second lien can be put on the property. Although this might make second mortgages difficult to get, if there is sufficient equity in the home so that a second lien is feasible, the borrower can always do a cash-out refinance, and thus the holder of the first lien has the option to accept the second or see the loan refinanced away. Alternatively, the approval of the first lienor can be limited by providing that there is no approval right if, after the second has been put on, the LTV is no higher than it was when the first lien attached. In this way, the first lienor gets the rights it originally bargained for.

3. **Elimination of other servicer-investor conflicts of interest.** The standardized forms of securitization of documentation should provide for mandatory arbitration of disputes between investors and issuers, and the appointment of a special trustee for investors where there is a conflict of interest between the investors and the servicer.

4. **Disclosure to investors**. There has been substantial variation in the quality of loan-level disclosure to investors about the quality of the mortgages in a pool. The FHFA and the SEC should agree on the disclosures that should be made by issuers in order to increase the transparency and information available to investors.

5. **Pricing disclosure**. The FHFA and the SEC should develop ways to increase the disclosure to the market of pricing information.

IV. Comments on the Garrett Bill

This section is divided into three parts—those provisions where the Garrett bill advances the goal of creating a private securitization market, where it falls short of this goal, and where it creates more impediments and disincentives that impair the achievement of the legislation's intent.

Where Garrett Bill Advances the goal of creating a private securitization market

The Garrett bill contains a number of provisions that address the issues outlined in sections I-III above.

1. Risk-retention. The bill repeals the 5% risk-retention provisions of the DFA. These are ineffective in any event, and create substantial impediments for firms that would like to engage in securitization.

2. Standard classifications of prime loans. The bill provides for the creation of several standard classifications of what are called "prime mortgages." However, it provides that some mortgage classifications could have "substantial credit risk." It is not clear how a prime mortgage can have substantial credit risk, and thus the language provides a basis for a serious future deterioration in underwriting standards. As a housing bubble develops, it suppresses defaults and delinquencies, so poor quality mortgages look less risky. In addition, as housing prices rise in a bubble, borrowers look for riskier mortgages in order to buy bigger houses with the same or lower monthly payments, and lenders are willing to make these loans because their inherent riskiness is obscured by the effects of the bubble. Exactly this happened in the period leading up to the 2008 financial crisis. If this bill is to reduce the chances of another housing bubble, in addition to encouraging the development of a private securitization market, it is necessary to assure that the mortgages created in the future are truly prime mortgages, and not mortgages "with substantial credit risks." At this point, the legislation does not accomplish this.

It is problematic to direct FHFA to establish categories of risk without specifying how they are supposed to do this. If they look at the last five years, those categories would look very different from what they would look like if they used the credit history of the last 25 years. The legislation should take account of the possibility that FHFA may not be as conservative as they should be when establishing what is a credit risk and what is not.

In this connection, it would be better to specify the minimum terms of a prime mortgage by statute, so that a future regulator cannot easily redefine the term. In 1990, before the affordable housing goals were established for Fannie and Freddie, a 20 percent downpayment was usual for a home and the rate of home ownership was still a robust 64%. The fact that the realtors want to sell more homes, and the homebuilders want to build bigger homes, should not affect what is a prime mortgage. With mortgage insurance, and coverage down to 60 LTV, it should be possible to offer a prime mortgage with 10 percent as a down payment. Leaving FHFA to establish rules for the future could be a serious mistake if the agency—under different leadership—decides to stimulate home ownership by reducing underwriting standards.

In addition, the bill does not instruct the FHFA to limit the number of different classifications so that the liquidity of a future private market is not so severely divided among classifications that the liquidity necessary for a TBA market is not impaired. A TBA market works if there is sufficient liquidity for a mortgage originator to hedge its risk by buying or selling mortgages before a pool has been developed. The current system works because the pools, overall, are very much alike in such qualities as prepayment rates. If there are many different classes of prime mortgages in the future, it may make it difficult to create homogeneous pools.

Finally, the legislation does not say that the standard mortgages it would create are the only mortgages that can be securitized, and that mortgages outside these standards can still be made, but cannot be securitized. That is essential to preserve a free market in mortgages while still protecting the securitization market against the kind of mortgage quality deterioration that occurred before the 2008 financial crisis. In other words, banks and other investors should be able to buy whole loans or portfolios of whole loans that are outside the standard classifications, but those mortgages may not be securitized. This could be rectified by stating that only "qualified securities" under sec 101(b) (4) can be securitized.

3. Standardization of securitization documentation. The bill authorizes the FHFA to create standardized securitization agreements and standardized requirements for trustees and for servicers. It also provides for mandatory arbitration of disputes among investors, servicers and securitization sponsors. However, it isn't clear why the sec 101(b)(2) limits the content of a standardized agreement to only the listed items. A different view of the provisions covered sponsors are outlined below.

4. Improvement in the QM provisions. By providing that the QM provisions in the DFA do not apply to a "qualified security" as defined in the bill, the legislation goes some distance toward eliminating the most troublesome element of the QM provisions in the DFA—the defense to foreclosure provision. Nevertheless, there are still ambiguities in the Truth In Lending Act (TILA) which could mean that a borrower will be able to defend against foreclosure by alleging a violation of one of the remaining exemptions from TILA. This should be remedied. The possibility that there might be nonmonetary defenses to foreclosure will make mortgage lending very risky in the future. Unless these TILA exemption ambiguities can be cleared away, the defense to foreclosure provisions in the DFA should be repealed.

5. **Exemption from registration**. By providing an exemption from registration under the Securities Act of 1933, as amended, the bill substantially eases and reduces the costs of the securitization process and hedging in the TBA market.

Where the Garrett Bill does not go far enough to achieve its goal

1. **Wind-down of Fannie and Freddie**. For the reasons outline above, the Garrett bill will not be effective in opening a market for private securitization if it does not eventually contain provisions which call for the gradual wind-down of the GSEs Fannie Mae and Freddie Mac through a reduction in their conforming loan limits.

2. **FDIC safe harbor.** Banks will find it very difficult to resume a role as securitizers as long as the FDIC's safe harbor continues to exist in its current form. The regulation is already in effect, so sec 102 (c) doesn't cover it. The bill should provide that if a pool of mortgages meets the standards as a prime mortgage and is securitized in conformity with the Garrett bill's provisions—i.e., as a qualified security—it will fall within the FDIC's safe harbor regulation.

3. **SEC Regulation AB**. Similarly, the bill should state that as long as a securitization complies with the provisions of the Garrett bill as a qualified security it will not be subject to rescission under Regulation AB.

4. Premium cash recapture. The proposed regulations on premium cash recapture, as outlined above, impose substantial costs on securitizers, especially those that do not have large balance sheets (to hold the recaptured cash over an extended period) or profit from the spread on mortgages they originate. Qualified securities under the Garrett bill should be exempt from the premium cash recapture provisions of the DFA.

5. Volcker Rule. It's already clear that the regulations under the Volcker rule will be so complicated that many securitizers will not be able to determine the conditions under which they can hedge their risks by buying or selling mortgages before their securitized pools are complete. The Garrett bill should provide that the Volcker rule applies only to insured banks, and not to "banking related entities." That will enable the affiliates of banks to hedge their risks in securitizations.

6. Second liens. Under current law, second liens can be added to home mortgages more or less at the will of borrowers, and without notice to the first lienor. Yet second liens create additional risks for the first lien that were not taken into account when that was negotiated. In commercial mortgages, second liens are not allowed without the consent of the first lienor on property. The Garrett bill should provide that second liens cannot be added to a home without the approval of the holder of the first lien, or that the first lienor's right of approval is ineffective if the LTV on the mortgage is no higher than it was when the first lien was negotiated.

Where the Garrett bill creates impediments to the development of a private market

1. **Standards for qualified sponsors**. One of the benefits of securitization is that it is open to anyone. The quality of a securitization does not depend on the wherewithal of the securitizer, but rather on the mortgages in the pool and the amount of subordination . The Garrett bill contains unnecessary provisions for the registration of securitization sponsors with the FHFA. These will provide opportunities for costly bureaucratic rules and regulations that serve no useful purpose but will add to the costs of securitization and narrow the competitive field. This provision should be eliminated from the bill.

2. **Disclosure of information**. It is important to understand that TBA market achieves liquidity because of a convention that all pools will have approximately the same makeup and characteristics. Disclosure is generally a good idea, but it could interfere with the development of a TBA market. The same is true for loan level information in Title II. These provisions should be carefully vetted by the Securities Industry and Financial Markets Association, which has developed the convention on what information about pools should made available in order to foster a TBA market.

Mr. Chairman and members of the committee, that completes my testimony.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
PETER J. WALLISON	NONE
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☑ No	☐ Yes ☐ No
6. If you answered yes to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
I DID NOT RESPOND TO QUESTION 5 BECAUSE I AM NOT REPRESENTING ANY ORGANIZATION. MY EMPLOYER, AEI, DOES NOT TAKE POSITIONS ON LEGISLATION OR OTHER PUBLIC POLICIES	
7. Signature:	
Peter J. Wallison	

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