BUILDING A SUSTAINABLE HOUSING FINANCE SYSTEM: EXAMINING REGULATORY IMPEDIMENTS TO PRIVATE INVESTMENT CAPITAL

HEARING

BEFORE THE

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U.S. HOUSE OF REPRESENTATIVES

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BUILDING A SUSTAINABLE HOUSING FINANCE SYSTEM: EXAMINING REGULATORY IMPEDIMENTS TO PRIVATE INVESTMENT CAPITAL

Wednesday, April 24, 2013

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Members present: Representatives Hensarling, Royce, Capito, Garrett, Neugebauer, McHenry, Campbell, Pearce, Posey, Fitzpatrick, Luetkemeyer, Huizenga, Duffy, Hurt, Grimm, Stivers, Fincher, Stutzman, Mulvaney, Hultgren, Ross, Pittenger, Wagner, Barr, Cotton, Rothfus; Waters, Maloney, Velazquez, Watt, Sherman, Meeks, Capuano, Clay, Scott, Green, Cleaver, Himes, Peters, Carney, Sewell, Foster, Kildee, Murphy, Delaney, Sinema, Beatty, and Heck.

Chairman HENSARLING. The committee will come to order.

Without objection, the Chair is authorized to declare a recess of the committee at any time.

Before we begin our hearing, I would like to take a moment to introduce the newest member of our committee. Keith Rothfus is a freshman Member representing the 12th District of Pennsylvania. He is an attorney with a law degree from the Notre Dame Law School, and a background in business law. He worked for the Department of Homeland Security from 2006 to 2007, and earned his BA from SUNY Buffalo. We are very happy to have him officially join our committee today.

And I am sorry you won't get recognized today to speak at your first hearing.

We will now turn to opening remarks. The Chair will recognize himself for 4½ minutes. This is the 7th full or subcommittee hearing that we have had on the topic of forging a new sustainable housing policy for America, one that is sustainable for homeowners, taxpayers, and our economy.

Clearly, all Americans want a healthier economy. They want a fair opportunity for all Americans to be able to buy a home that they can actually afford to keep. It is clearly time to displace the false hopes and broken dreams which have arisen from a system of misdirected government policies that regrettably incented, browbeat or mandated financial institutions to loan money to people to buy homes that all too often they could not afford to keep.

Regrettably, on this topic there have recently been a couple of disturbing press reports concerning actions of the Administration.

On April 2nd, The Washington Post had the headline, "Obama Administration Pushes Banks to Make Home Loans to People With Weaker Credit." Had the story been posted on April 1st, I might have thought it was an April Fool's joke. I ask the question, have we as a Nation learned nothing?

The article went on to say that the Obama Housing officials were urging Obama Justice officials to offer banks the equivalent of get-out-of-jail-free cards if they would lend money to folks with weaker credit.

Ed Pinto, the former top Fannie Mae executive and a recent witness before our committee, said in response, "That would open the floodgates to highly excessive risk and would send us right back on the same path we are just trying to recover from."

The other disturbing headlines came from the L.A. Times and many other major publications on April 10th. The L.A. Times headline was, "Obama budget projects $943-million bailout for key housing agency." Regrettably, the President's budget does indeed call for a bailout of FHA. That institution has abandoned its historical mission, endangered the future of the agency, and regrettably put taxpayers at risk.

Many of us believe that there are three steps to a sustainable housing policy for our Nation: one, to gradually reduce and eventually eliminate the government guarantee of Fannie Mae and Freddie Mac; two, to reform the FHA so that its mission is explicit, targeted, and paid for; and three, to remove the artificial barriers to private capital coming into the market, which is the subject of today's hearing.

Now, it may be a challenge for members of this committee to come to agreement on all the provisions of the first two steps, but surely, surely, we can find some way to come together on the third, and that is removing barriers to entry of private capital coming into this market. After all, the Administration has clearly been on the record urging us to do just that. This is a quote from the Administration's housing White Paper: "We need to scale back the role of government in the mortgage market and promote the return of private capital to a healthier, more robust mortgage market." Again, that was in the Administration's White Paper, which regrettably has been left to gather dust for about 2 years.

Then-Secretary of the Treasury, Secretary Geithner, on behalf of the Administration, said, "The administration is committed to a system in which the private market, subject to strong oversight and strong consumer investor protections, is the primary source of mortgage credit. We are committed to a system in which the private market, not American taxpayers, bears the burden for losses."

HUD Secretary Donovan, "As we have made clear, this administration believes that private capital needs to come back and that the government's footprint in the housing market needs to be much smaller. In order to do this, some provisions of the Dodd-Frank Act, particularly QM and QRM, will have to be carefully examined given their potential impact on the mortgage market."

I know that many of my friends on the other side of the aisle have much invested in the Dodd-Frank Act and its brand, and I respect this, but if you agree that private capital and not taxpayer capital should be the foundation of our housing finance system, then I hope you will have open minds that perhaps some limited number of provisions of the Dodd-Frank law perhaps could be refined and improved upon at this time.

At this time, I yield to the ranking member for 5 minutes.

Ms. WATERS. Thank you, Mr. Chairman, for holding this hearing.

Today, we are examining regulatory impediments to private capital coming back to the housing markets, even as we have very fresh memories of a largely unregulated shadow mortgage industry selling billions of dollars of toxic securities to investors and devastating millions of American families. Interestingly, we are not examining the private sector impediments to private capital returning. For example, how many investors have confidence that the institution selling new mortgage-backed securities won't try to swindle them again? Have banks fixed their servicing practices that harmed both borrowers and investors, and do we really think investors have forgotten that?

According to the GAO, the financial crisis reduced the wealth of Americans by $9 trillion. This is not to say that I think that our current predicament in which the taxpayer is backstopping 90 percent of all mortgages is sustainable. Nearly everyone on both sides of the aisle agrees that we must reduce the taxpayers' current exposure. However, it was FHA, Fannie Mae, and Freddie Mac that stepped up to ensure housing finance continued when the private market disappeared.

Congress passed the Dodd-Frank Act to help restore investor confidence in the housing finance markets by providing clear rules of the road. To name a few, the Act provides legal certainty to banks only when underwriting safe and sound mortgages. Congress also requires issuers to have skin in the game by retaining some of the risks, thus aligning their incentives with investors. To provide investors with better information, Dodd-Frank improves securities disclosures, including requiring better data on the underlying assets as well as reforming and imposing liability on the credit rating agencies when analyzing those securities.

Even if these changes are implemented, we are still a long way from restoring the level of investor confidence necessary to restart the private label security markets. I continue to support proposals, including aspects of Mr. Garrett's securitization bill from last year that recognized the government's role in encouraging further standardization in these markets. I also think the government can work with the private sector in other areas, like helping to establish a model purchase and sale agreement, eliminating the conflicts of interest some banks have that service first liens while also owning the second lien on the same property or transferring servicing generally to institutions that have much higher levels of personal contact with borrowers.

But if we are really looking for impediments to bringing back private capital, we need look no further than this committee. While the GSEs are incrementally taking steps to reduce their market presence, it is Congress that must pass comprehensive housing finance legislation to bring about real reform. This legislation will only be successful if it ensures a continuance of stable products such as the 30-year fixed-rate mortgage, provides all eligible borrowers with access to credit, and supports affordable rental housing options.

Two weeks ago, I hosted a roundtable of experts, the first in a series to discuss housing finance reform and a path forward. I think participants found the forum conducive to digging deeper into the issues to understand policy choices. One conclusion from this roundtable, for example, was that the objectives I just outlined must be met or can be met only if the government backstops some level of credit risk. I am told that there are now over a dozen different comprehensive proposals to reform our housing finance system, many with bipartisan support. I find it disappointing that while we have convened more than 20 hearings on FHA and the GSEs over the last 3 years, we have not considered any of these ideas. I hope that our witnesses will explain to my colleagues the need as well as the opportunity we have to build a stable mortgage market for generations to come.

Thank you, Mr. Chairman. I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from Texas, Mr. Neugebauer, for 2 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman, and I appreciate you holding this hearing as we examine the regulatory impediments to private capital returning to the housing market.

One of the things we know is that sometimes what government does when they are trying to fix one problem is they create another one, and a lot of the legislation that was passed in the last few years was to try to address what happened in 2008, but basically, what we have done in trying to "fix" the mortgage market in this country is we have nationalized the mortgage market in this country.

As the chairman mentioned, 9 out of every 10 mortgages in this country have some Federal backing, FHA and the GSEs continue to dominate the markets, and while there is some private activity, it is a very nominal amount of private activity, and the other thing that we have done is, I think most people who are investors in those securities, debt securities are interested in credit risk, identifying what is the credit risk, what is the interest rate risk, but what we have done with some of the new regulations is we created a new category of risk called regulatory risk. And as we talk to a lot of the market participants, they are having a difficult time trying to price what this regulatory risk is because there is so much uncertainty and so many unanswered questions because, as we speak, rules continue to change, rules continue to come out, and so I am looking forward to hearing today about some ways that we can remove some of the impediments, bring private capital back in because the big beneficiary will, if we have a robust housing finance market, everybody wins, but more importantly, the American taxpayers have already put $200 billion into the mortgage finance entities. And our ultimate goal is to have a robust market but also to make sure that we get the taxpayers out of the business of guaranteeing their neighbors' home loan in the future.

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

Chairman HENSARLING. The Chair now recognizes the gentlelady from New York, Mrs. Maloney, for 2 minutes.

Mrs. MALONEY. Thank you, Mr. Chairman, and Madam Ranking Member.

I welcome all the panelists, particularly those from the district which I am honored to represent: Mr. Chris Katopis, who is also a leader in the Greek-American community; and Mr. James Millstein, who successfully restructured AIG into a form which was making a profit.

The current homeownership rate in the United States is 65 percent, and for every percentage point that drops, another 3 million Americans exit the homeownership market, and I believe, going forward, we have to look at answers that help the middle class have access to financing and homeownership.

The Wall Street Journal 2 days ago wrote that existing home sales are down as inventories tighten. So getting the housing finance structure right is tremendously important to our economy going forward. Some economists estimate that it is as much as 25 percent. So it is very, very important. And with Fannie and Freddie still in conservatorship and the Federal Government guaranteeing 90 percent of the mortgage originations, I think we all agree that changes are needed. But with $6.5 trillion of the $10 trillion guaranteed by the government, in my opinion, we need a transition period, and we need to be very careful how we move forward. We need the private sector to play more of a role, but at the same time, we need the middle class to have access to credit, the 30-year mortgage, and others that have built the stability in our economy.

My main question today is, how do we protect the taxpayers from bearing the risk of housing finance in the future? None of us want to see another government bailout, and I am also interested how any changes would impact homeownership and interest rates as we move forward in the future. I look forward to the testimony today. Thank you for being here.

Chairman HENSARLING. The Chair now recognizes the gentlelady from West Virginia, Mrs. Capito, for 2 minutes.

Mrs. CAPITO. Thank you.

I would like to thank the chairman and the ranking member for holding this morning's hearing as we continue to look to the future of housing finance. As you can tell from our opening statements, I think we have a lot of consensus here. As our Nation's housing finance system slowly recovers, the current imbalance between private sector and government in our markets remains clear. While we might have consensus and it sounds fixable, it is not as easy as it sounds. We know this from the many hearings that we have had.

Although what a suitable mortgage market will look like remains unknown, there is an agreement that the current environment of government dominance is not reasonable nor is it a long-term solution, so I would encourage that we work toward a sustainable housing finance system which promotes a broader private marketplace where creditworthy customers can find affordable credit in a safe and sound system which protects taxpayers from future losses.

This starts with applying smarter regulations and not adding new regulations on top of the old. Unfortunately, with the implementation of Dodd-Frank, the current regulatory structure does not foster this type of environment, and expansive regulations being implemented only add to uncertainty and impose more time and resources on private institutions trying to deploy their capital.

These regulations especially impact those who cannot bear the weight of the new and restricting rules, further restricting credit availability. Rather, the impediments to private capital should be addressed through consistent regulations that coincide with efforts to restore an appropriate balance between the private market and government.

While I hope to return government's occupancy and housing finance to the private market as quickly as possible, I would reiterate that these efforts need to be made towards the attention to the customer or the consumer. Withdrawing government's presence should at the same time correspond with facilitating opportunities in the private market so we can defend market stability and create growth.

Again, I thank the chairman for holding the hearing, and I look forward to the testimony of our witnesses and thank them for coming.

Chairman HENSARLING. The Chair now recognizes the gentleman from Georgia, Mr. Scott, for 3 minutes.

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

This is a very interesting topic on which I have quite a bit of interest, and I think that the title of this hearing is examining regulatory impediments to private investment capital. I think it is important, but the fundamental issue here that we must first address is whether or not the current health of the private mortgage market is strong enough to bear the risk of bringing back private investment capital.

This is particularly true, for we know that the displacement of private sector competition is now so large that roughly 90 percent of all residential mortgage originations are securitized into government-backed, mortgage-backed securities.

So is there sufficient capital in the private market to make up for what the GSEs are doing and to make sure that we still have the guarantee of the 30-year mortgage situation? If our secondary mortgage market were entirely privatized, does sufficient capacity exist among both bank and non-bank lenders to absorb loans on balance sheets until they can be securitized or sold?

Then, there is a cascading number of questions. To what extent, for example, do guaranteed fees charged by Fannie Mae and Freddie Mac still need to rise in order for private label securitizations to compete in the market? And do we know the capacity of the private market to step in and provide credit if Fannie and Freddie were to raise their prices? Will the supply of mortgage credit expand as a reaction to additional price increases? Will it have the effect of simply limiting access to qualified borrowers or both? And then is there a concern that raising the guarantee fees further without also reforming the Enterprises will not break the GSEs duopoly over securitization but instead bring in enormous profits. So, we have some very perplexing issues here.

Fundamentally the issue should be, is the private market really capable? Can they handle the risk, and can they do what the GSEs do? They were put here for a reason, and the reason was because the private sector wasn't doing this, so we have to make sure, before we throw the baby out with the bath water here, that we protect the baby.

Thank you, Mr. Chairman.

Chairman HENSARLING. The Chair now recognizes the gentleman from California, Mr. Campbell, for 1½ minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman, and good morning to the panel.

Today in this hearing, we are going to look at, as the title says, impediments that exist in the structure or regulatory structure, impediments to bringing private investment capital back into the housing market, but the one thing I think we should all agree on is that we don't want to create some new impediments to private capital, and right now, there is an idea out there about using eminent domain to seize mortgages, which is gaining a little traction with some cities in my home State, and actually across the country, and we will discuss this more during the hearing, and about the issues, but for the purposes of this hearing, it has a lot of problems. It is hard to convince private capital to come in when their security could be at risk with the idea that a municipality could just arbitrarily decide, okay, we are going to seize your mortgage, and write down your security. And by the way, we are going to put a bunch of that money in our pocket and a bunch of it in the pocket of the private company which is pushing this idea.

So it seems to me, and this is a bipartisan issue—Chicago Mayor Rahm Emanuel, when this was brought up in front of Chicago, said, "The idea of using eminent domain is not one that I support because I don't think it is the right way to address the problem."

So I look forward to hearing from the panel, and I yield back. Thank you.

Chairman HENSARLING. That concludes the opening statements.

I will now welcome our distinguished panel of witnesses and introduce them. First, Mr. Chris Katopis is the executive director of the Association of Mortgage Investors (AMI). According to its Web site, AMI was formed "to serve as the industry voice for institutional investors and investment professionals with interest in mortgage securities."

Previously, Mr. Katopis has served on the Hill as a legislative staffer.

Mr. Martin Hughes is the CEO of Redwood Trust, which I believe may be one of the few, if not the only securitizer of private label mortgage-backed securities at the moment. He has over 15 years of senior management experience in the financial services industry. He is a CPA, and holds a bachelor's degree in accounting from Villanova.

Mr. James Millstein is the CEO of Millstein & Co. He previously served as the Chief Restructuring Officer at the Treasury Department where he oversaw AIG's restructuring efforts. He has a JD from Columbia, a master's from UC Berkeley, and a BA from Princeton.

Finally, Dr. Arnold Kling is a senior scholar and a member of the Financial Markets Working Group at the Mercatus Center at George Mason University. He has previously served as a Senior Economist at Freddie Mac and a Senior Economist at the Federal Reserve. He has a Ph.D. in economics from MIT.

Each of you will be recognized for 5 minutes to give an oral presentation of your testimony.

Without objection, each of your written statements will be made a part of the record. Some of you have testified before, so you are familiar with our light system. The green light will be on for 4 minutes. When it turns yellow, you have 1 minute to sum up. When it turns red, I think you know what that means.

After all of you have finished presenting your testimony, each member of the committee will have 5 minutes in which to ask any or all of you questions.

Mr. Katopis, you are now recognized for 5 minutes.

STATEMENT OF CHRIS J. KATOPIS, EXECUTIVE DIRECTOR, ASSOCIATION OF MORTGAGE INVESTORS (AMI)

Mr. KATOPIS. Good morning, Mr. Chairman, Ranking Member Waters, and distinguished members of the committee. We appreciate the opportunity to testify this morning. The Association of Mortgage Investors was formed as a primary unconflicted trade association for investors and residential mortgage-backed securities. We, along with investors from life insurance companies, State pensions, State retirement systems, and university endowments invest in the U.S. mortgage market. A key goal of the system today is to move credit and mortgage capital from investors to borrowers and then back again. The more private capital that is in the system, the more opportunities there are for borrowers and the more housing opportunities exist. At essence, securitization today is broken, limiting the availability of housing credit and the reach of the American dream of homeownership.

Mortgage investors share your frustration with the slow restoration of the housing market and the need to assist homeowners who are truly hurting. In fact, the market for residential mortgage-backed securities today has virtually ground to a halt since the financial crisis for the reasons we describe in detail in our written statement.

Today, Members of Congress have said mortgage investors are on strike. We assure you, Mr. Chairman, that we are on strike, but we would like to get back to work, and with your help, perhaps that will be possible in the near future.

So what do we do? For example, we are hopeful that meaningful solutions can be implemented more quickly, and we believe that our interests are aligned with responsible homeowners. As difficult as it may be to believe, many of the most sophisticated investors in the market were as victimized and abused by big bank servicers as many consumers. Investor-managed funds are essential to rebuilding the private mortgage market.

However, Mr. Chairman, investors will only return to a mortgage market which is transparent, has data on the underlying mortgages backed by enforceable reps and warranties, addresses servicer conflicts of interest, and provides protection through law and regulation.

The current mortgage market suffers from a thorough lack of transparency as well as a number of other items outlined in my testimony: poor underwriting standards; a lack of standardization concerning mortgage documents; numerous conflicts of interest; defective and improper mortgage service practices; an absence of effective legal remedies for contractual violations; and unwarranted State and Federal interventions in the mortgage market, for example the proposed use of eminent domain as a foreclosure mitigation tool.

In terms of competition, private investors in the mortgage-backed securities space right now are crowded out by the government to a large degree. Mr. Chairman, the playing field is not level for investors, and even if FHFA, as conservator of the GSEs, were to raise g-fees to market levels by regulatory order, this would not solve the problem in itself. Fannie Mae and Freddie Mac are in the same business as private mortgage investors and mortgage insurers, bearing credit risk in exchange for financial compensation. And going forward, the Enterprises should not have their costs subsidized by the advantages of government sponsorship. Congress should prepare a transition plan to end the government sponsorship and have the credit risk-bearing functions of these entities fully privatized to ensure a competitive level playing field.

Mr. Chairman, the return to private capital requires several steps. There is no one silver bullet. There is no "easy button" like we see on TV. What can we do? Congress has already acted in a way that could be exemplary. They solved a problem very similar to this in the 1920s with the stock market crash of the corporate bond market. The Trust Indenture Act was enacted by Congress in the 1930s to restore the corporate bond market, and it works so well today that most corporate bond market traders have it work without even knowing it is in existence.

It creates a number of responsibilities and obligations for trustees, resolves intercreditor rights, and creates certain standards, structures, and systems that help the market go forward. We hope these can be emulated for RMBS to bring private capital back into the space.

Beyond that, we hope that Congress can consider the following: facilitating a single national Internet database of mortgages; mortgage servicing standards that address the needs of investors as well as borrowers; and a single national uniform foreclosure law.

So we thank you very much for this opportunity to testify. AMI is pleased to be a resource for the committee as you continue your efforts to bring private capital back to the U.S. mortgage market for generations to come. Thank you.

[The prepared statement of Mr. Katopis can be found on page 61 of the appendix.]

Chairman HENSARLING. Mr. Hughes, you are now recognized for 5 minutes.

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

Mr. HUGHES. Good morning, Chairman Hensarling, Ranking Member Waters, and members of the committee. I appreciate the opportunity to testify here today on what could be done to accelerate the return of the private secondary market.

My testimony is singularly focused on the perspective of the institutional investors that are the buyers of senior classes of securities backed by mortgage backs. Those investors are the single most critical variable to consider as you take steps to produce a robust mortgage-backed, private mortgage-backed market. Simply put, these investors have the money, and without their participation, there is no market.

In the wake of the financial crisis, investors in private mortgage securities lost confidence that their rights and interests in the securities they own would be respected and, consequently, that their investments were safe and secure. In response, some large senior MBS investors who previously had significant capital obligations to the private MBS space now have little or no participation.

It doesn't add up. In today's financial world awash with liquidity, with senior investors searching for safe, attractive yield, the private MBS market should play a much larger role as an attractive investment asset, as it was in the past.

So in terms of recommendations on how we can get there, it will take a combination of efforts by market participants, Congress, and regulators. My recommendations are threefold: first, meet investors' demands for stronger structural protections, increase transparency, and align interest through the entire mortgage chain; second, give the private MBS market room to develop and grow by having the government reduce its market share on a safe and measured basis—this can be accomplished through further increases in guarantee fees and reductions in loan limits; and third, remove the overhang of unfinished regulation by requiring that unfinished rules that are past deadline to be issued within 4 months are subject to a 4-year moratorium. My written testimony contains detailed recommendations for each of these three categories.

In the interest of time, I would like to single out one issue for special mention because it has not received the attention equal to the harm it has caused, and that is the need to control the systemic threat that second liens, otherwise known as home equity loans, pose to first lienholders. We can do this by giving first lienholders the ability to require their consent to a second lien if the combined loan to value with all other liens will exceed 80 percent. During the housing bubble, homeowners used home equity lines to extract record levels of equity from their homes and also as a substitute for a cash downpayment. The rise in home equity lending increased monthly payment obligations for borrowers and reduced the amount of equity remaining in their homes, leaving borrowers vulnerable to price decline. As a result, 38 percent of borrowers who used these loans found themselves underwater compared to only 18 percent who did not, and from a delinquency standpoint, even for prime borrowers, the delinquency rate was 114 percent for borrowers who had taken out seconds. This proposal would allow borrowers to tap into their equity while preserving a level of protection for first lien investors.

If we move back to Redwood, the success of Redwood's private securitizations proves that this market can be fixed and that it is ready to assume a larger role in our housing finance system. Since we restarted securitization in 2010, Redwood has securitized $5.6 billion of jumbo loans in 14 transactions. We plan to securitize $7 billion in transactions this year, and we have already completed 5 transactions to date. Our success didn't happen by accident. We listened to investors, and worked hard to meet the new requirements by putting together transactions that included more comprehensive disclosures, better and simpler structures, and new enforcement mechanisms for representations and warranty. Currently, our primary focus has been on the prime jumbo market. We are limited to the prime jumbo market at this point because we cannot compete with the price and market advantages the government has conferred to the GSEs. Once the playing field is level, we stand by ready to securitize prime loans of any size, and we are not that far off. For example, today the rate on a Redwood jumbo mortgage is 3.875 percent, on a Wells Fargo mortgage on an agency conforming it is 3.65 percent, and on an agency conforming completely it is 3.5 percent.

In conclusion, Mr. Chairman, I commend you for focusing this hearing on investors. I firmly believe that the private secondary mortgage market can grow quickly to provide liquidity to a very large share of the mortgage market without the need of a government guarantee if the needs of investors are met and the government gives the private markets an opportunity to grow. Thank you for the opportunity.

[The prepared statement of Mr. Hughes can be found on page 50 of the appendix.]

Chairman HENSARLING. Thank you.

The Chair now recognizes Mr. Millstein for 5 minutes.

STATEMENT OF JAMES E. MILLSTEIN, CHIEF EXECUTIVE OFFICER, MILLSTEIN & CO.

Mr. MILLSTEIN. Thank you. Chairman Hensarling, Ranking Member Waters, and members of the committee, thank you for the opportunity to testify today.

Chairman HENSARLING. I'm sorry, could you pull the microphone a little closer, please? Thank you.

Mr. MILLSTEIN. I am losing precious time.

Chairman HENSARLING. We will give you 5 seconds.

Mr. MILLSTEIN. The question we now face, 5 years into the conservatorship over Fannie and Freddie, and a market in which 90 percent of all new mortgage originations are ending up on the balance sheet of the Federal Government, is how to back the government out of a market it now dominates without triggering another credit contraction and downturn in house prices? How do we design a transition plan to a market where private capital plays the leading role in credit formation but which also protects the economy and ensures access to credit?

During my recent tenure as the Chief Restructuring Officer at the Treasury Department, I had primary responsibility for the restructuring and recovery of the government's funding commitments to AIG, commitments which rivaled in size the amount of capital today invested in Fannie and Freddie. In downsizing AIG and recovering the taxpayers' investments in it without destabilizing the broader financial markets in which it operated, we faced a problem similar to the problem facing Congress today: how to reduce the systemic importance of Fannie and Freddie without undermining stable credit formation in the mortgage markets.

Although housing reform is more complex in several respects than the AIG restructuring, I believe that a similar corporate finance and restructuring solution to that which we employed with AIG, combined with a broader housing finance reform of the sort you have just heard, could accomplish three important goals for which I believe there is broad bipartisan support: one, ending the conservatorships and the creeping nationalization of the mortgage markets; two, fully recovering the taxpayers' substantial investments in Fannie and Freddie; and three, creating conditions under which private investment capital will return to a market now almost completely dominated by the Federal Government. Any credible transition plan to reduce the government's footprint needs to ensure that private capital will, in fact, substitute for what the government is providing through Fannie and Freddie today.

To ensure that outcome, there are four key features of the proposal. First, we need to wind down the government-sponsored hedge funds that Fannie and Freddie ran. We need to terminate the government charters that created an implied guarantee of their debt and recapitalize and sell their mortgage guarantee businesses to private investors.

Second, to be able to continue to tap the broad and deep pool of capital that the government guarantee permits, however, until private markets fully heal, we need to provide government reinsurance for qualified MBS in exchange for a fee properly calibrated to protect taxpayers against the risk of loss. This would be similar to the FDIC's Deposit Insurance Program and would represent a dramatic shift in structure and substance from the pre-crisis model of a free implicit guarantee of undercapitalized government-sponsored entities.

Third, remove structural impediments to PLS issuance. Along those lines, I am in agreement with much of what you have just heard from both of these gentlemen.

Fourth, fund affordability initiatives in a transparent fashion by assessing a fee on all MBS issued with this government reinsurance.

For better or for worse, the truth is that Fannie and Freddie play a central role in credit formation of the mortgage markets today, a role too big for banks, too big for private mortgage insurers or private institutional investors to displace overnight or even over the next decade, particularly in the aftermath of the greatest credit crisis in 4 generations from which these investors are still reeling. So, in light of the continued weakness in the appetites of banks, private insurers, and private investors for taking mortgage credit risks, our plan calls for the recapitalization and privatization of Fannie and Freddie's mortgage guarantee business and the creation of a separate independent agency to provide reinsurance on qualified mortgage-backed securities, which reinsurance would be behind in the first instance the substantial capital then owned by the newly privatized guarantee businesses. We think this is a practical and executable transaction and transition out of the conservatorships to a new market structure in which well-regulated private insurers put substantial private capital ahead of the government on its guarantee.

In the interest of full disclosure, my firm owns certain of the junior preferred securities issued by Fannie and Freddie. These securities are only entitled to a recovery if the government is repaid in full on its investments. The merits of my proposal for ending the conservatorships, however, do not rise and fall on whether those securities are entitled to a recovery. The primary objective of the proposal is to ensure that mortgage credit remains broadly available in the transition from a system dominated by the government today to a system in which private capital takes the lead in mortgage formation in the future.

Thank you.

[The prepared statement of Mr. Millstein can be found on page 85 of the appendix.]

Chairman HENSARLING. The Chair now recognizes Dr. Kling for 5 minutes.

STATEMENT OF ARNOLD KLING, MEMBER, MERCATUS CENTER FINANCIAL MARKETS WORKING GROUP

Mr. KLING. Thank you, Chairman Hensarling, and Ranking Member Waters.

My fellow panel members are much more familiar than I am with current practices. I have spent the last 12 years teaching at a high school.

And I am going to be a bit pedantic today and say that technically all of the capital for mortgages today comes from private capital. It is private capital. It is now, always has been, and always will be the savings of the private sector that gets channeled into mortgages.

The difference is what kind of intermediary and what kind of intermediation takes place to translate that private capital into mortgages, and so the purpose of this hearing is quite correct, and several people have stated it: The issue is, how can that intermediation take place without taxpayers taking so much of the risk? That is kind of the fundamental question here.

I want to start out by pointing out, and maybe we can discuss this more later, that a major form of risk that we should be concerned with that the taxpayer is taking is interest rate risk. There is a real potential, while everyone focuses on credit risk, for taxpayers to end up taking interest rate risk in ways people haven't anticipated.

The other point to make about this intermediation is that it does not necessarily require securitization. I am old enough to remember when savings and loans were the intermediaries that supplied most of the capital to the mortgage market, and there are some pros and cons to going back to that model, and we shouldn't close ourselves off to that model.

With that said, I have seven recommendations to run through for improving the intermediation of private capital. And the first is to stop demonizing mortgage originators. Mortgage originators were told after Dodd-Frank that they should not originate any loans that violated the rules. And then they were told if they asked what the rules are, "We are not going to tell you yet." That is not a sustainable way of dealing with mortgage originators.

Second, stop demonizing mortgage servicers. Mortgage servicing is an industry that, until recently, was kind of shaving nickels off of its cost of doing business and has been basically beaten up to the tune of having to spend thousands and thousands of dollars per loan because other people are telling them that they should be able to cure loans. And it has just completely thrown that business apart. So the net result is that there are fewer originators today and fewer people want to do servicing on anything other than a squeaky clean loan today. And, the joke I have heard recently is that if you want a loan, you can either go to Wells Fargo or Wells Fargo, and mortgage rates are high because the origination market and the servicing market have been beaten up.

As far as phasing out Freddie Mac, Fannie Mae, and FHA, I think that is a simple matter of phasing down their maximum loan sizes. I think you should consider, if you at all want any kind of national market in mortgages, to have a national title system. The fragmented title system doesn't work, and you can also get rid of the cost of title insurance by switching to something called a Torrens title. I think that a national model for loan servicing agreements, and people have already spoken about this, would be useful as well.

I would say continue to develop a national standard for conforming loan for mortgage securities. Again, that is a constructive step.

And finally, continue to support consumer protection, financial literacy, and programs to help families save for downpayments. It frightens me, frankly, when people complain that 65 percent homeownership is too low. Buying a home is a complex transaction. In the United States, when you are putting 10 percent down, that is way more than we allow people to borrow to buy stock. We require 50 percent margin to buy stock. So we are putting people into very complex transactions, and I think we need to make sure that they have the savings to deal with it and the financial literacy to understand what they are doing. Thank you very much.

[The prepared statement of Dr. Kling can be found on page 80 of the appendix.]

Chairman HENSARLING. Thank you, Dr. Kling.

And thank you to all the panelists.

The Chair now recognizes himself for 5 minutes. I think I hear a concurrence among the panel and hopefully among many Members who gave opening statements that we all want a system with more private capital, but some have begged the question, is there enough private capital, and will it come back in?

I think it was you, Mr. Hughes, who said presently the system is "awash in liquidity." Was that your phrase?

Mr. HUGHES. That was my phrase.

Chairman HENSARLING. And just how much liquidity do you see awashing around?

Mr. HUGHES. In fixed income funds, there is $3.5 trillion, and that is not counting banks' balance sheets or what is available on insurance companies' balance sheets. So personally, I don't think it is a money problem.

Chairman HENSARLING. I believe if I have the right statistic in front of me, the current size of the U.S. residential mortgage market is roughly $10 trillion. I have heard some concern from many that private capital could not backfill a market of this size, so I guess a question, what is the optimum size of the U.S. mortgage market? Is it $8 trillion? Is it $10 trillion? Is it $12 trillion? Who is qualified to tell me what the optimum size of the U.S. mortgage market should be? No takers?

We have one taker.

Mr. Millstein?

Mr. MILLSTEIN. I will say this: In 2000, at the turn of the century, the size of that market was $4.5 trillion of outstanding mortgage indebtedness. In the 7 years between 2000 and 2007, we more than doubled the aggregate debt on the housing stock of the United States to $11 trillion. It is off a trillion now with foreclosures and debt repayment, but we are clearly at a very inflated size of the mortgage market.

Chairman HENSARLING. That does beg the question of what the optimum size of this market ought to be. I myself don't know the answer to that question. But I do believe also, maybe it was in your testimony, Mr. Hughes, you noted that the auto loans, credit card loans, and commercial real estate loans are up and functioning while the private residential mortgage-backed securities market is barely developed. So is there something about the residential mortgage market that makes it immune to the laws of supply and demand, and won't they ultimately determine the size of capital for the market?

Mr. HUGHES. There is no shortage of money. The problem is the risk that investors see in that market, from being burned and waiting to see that steps have been taken to improve investor protection mechanism, servicing, and a number of factors that we both have talked about.

Chairman HENSARLING. Dr. Kling, you didn't discuss it in your oral testimony, but I found in your written testimony an interesting discussion of, I guess the Canadian model, their version of a 30-year amortized model. We have heard some Members say they are concerned that we might end up with a model where the 30-year fixed no longer exists. I am under the impression that it exists in jumbo now where the GSEs do not operate. Does anybody wish to offer a contrary opinion?

If not, let me ask about this model, because I know we had testimony when FHA Director Ed DeMarco came and testified before us regarding the 30-year fixed, "It is not necessarily the best mortgage product for a home buyer, especially a first-time home buyer." I can see a system where anybody who wanted it, I would hope it would appear in the market, I observe it appears in the market, but I am also curious in the Canadian model, as I understand it, you have a 5-year reset on the interest rate, yet it amortizes over 30 years, which means a number of our constituents have found that they were underwater with their mortgages, had challenges engaging in refinancing, then also the refinancing costs, the closing costs kept many from doing it. Had they had access to this model, many of them would have seen their monthly payments go down and might have been able to keep their home. Is that correct?

Mr. KLING. I don't—I guess I wouldn't champion the 5-year rollover as something that would have done a whole lot in this crisis. I think a lot of these people were underwater almost from day one. Maybe a few of them who took out really crazy adjustable rate mortgages would not have taken them out and would have taken out a 5-year loan.

The main thing is that we don't know where the risk on the 30-year product resides. We don't know where it resided when Freddie Mac and Fannie Mae were at their peak. We just didn't observe the kind of spike in interest rates that would have shown us what happened. My guess is that either Freddie Mac or Fannie Mae would have gone bankrupt because of the interest rate they took or the derivatives that—

Chairman HENSARLING. Regrettably, I need to cut you off and attempt to set a better example for the committee. I am over my time.

I now yield 5 minutes to the ranking member.

Ms. WATERS. Thank you very much, Mr. Chairman.

I would like to thank all of our panelists who are here today. It seems as if there is a consensus on some things. It appears that everybody agrees that there is a lack of confidence and that there needs to be transparency and some other kinds of things.

I would like to particularly thank Mr. Millstein for his participation in the discussion, not just here today, but the fact that you have come up with some real live proposals, and have been helpful to me and to others.

[Dogs barking].

Ms. WATERS. That is the servicers.

Chairman HENSARLING. Are they German Shepherds?

Ms. WATERS. I have a question for Mr. Katopis. Do you agree that mortgage servicers have been demonized and that the "gotcha" regulators Mr. Kling references have been unfair to servicers?

Mr. KATOPIS. With all due respect, Congresswoman, we disagree. We think that the servicing model that has existed for decades is not sufficient for the economic environment we are in now. We have a lot of distressed borrowers who should be helped, who may need some special touch, and we have seen a lot of reforms in this space, but still we think more needs to be done. And in particular, for the topic of this hearing, bringing private capital back into the markets, we need servicer reform that not only addresses the needs of distressed borrowers but of investors. And remember when I speak of investors, I am talking about all the limited partners we have, whether it is CalPERS, retirement systems, or university endowments, because returns for those investors are harmed by the servicing practices we are seeing today.

Ms. WATERS. Absolutely. And despite the fact that some of us are real advocates for our consumers and we want to make sure that they have available to them the kind of mortgages that are fair, we also are concerned about investors. And I have been concerned about the fact that various servicing settlements from regulators and State attorneys general allow servicers to meet the terms of the settlements by writing down the loans that are owned by investors. Do you think that is fair?

Mr. KATOPIS. That is an absolutely keen observation. We are very concerned, and my testimony touches on what I call unwarranted Federal and State interventions in the market. A lot of these settlements are extremely troubling for mortgage investors because they are having some of these institutions, these too-big-to-fail institutions settle with other people's money, the first lien investors, so we really appreciate your attention to these matters.

And we have asked for more transparency. We have contacted a number of Administration officials, including the National Mortgage Settlement Administrator, for more transparency, and we hope that there is action taken on that front. And as an aside, I talk about who are mortgage investors. I was a Hill staffer. I had a TSP. I was in the G or C fund, I would like to think anyone who has a TSP is a mortgage investor, too, on one level, so I claim as many as I can.

Ms. WATERS. I want to get to Mr. Millstein. In your testimony, you describe some of the private label mortgage securitization deals that have occurred since the 2008 financial crisis, and you note that they are structured to provide immense protection for investors. This includes both high downpayments for the loans, underlying the securitizations, the high FICO scores for borrowers. This also includes the fact that the issuers of these new private label mortgage securitizations retain the subordinated tranches in these deals, meaning that the issuers take losses before other investors take losses. Given the extremely conservative nature of these issuances, is it reasonable to expect that private investors are willing to absorb all of the credit risk currently borne by Fannie Mae and Freddie Mac?

Mr. MILLSTEIN. In my testimony, I described the deal done by Mr. Hughes. And I think this is important for the committee to understand, that while Redwood is really pioneering now this private label securitization market, they are doing it with enormous equity cushions and subordinated tranche cushions to protect the senior investor. You could have a downturn as severe as we had in 2007 and 2008 and the investors in the Redwood Trust recent issuances would not lose a dime because of the enormous cushion. So there is not a lot of credit risk being taken by the private market today. And that is for good and valid reasons. The Government of the United States has two of the largest funding sources for mortgages in conservatorship. Until you guys clarify what is the fate of those, the fate of the housing market will remain uncertain for private investors.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentlemen from Texas, Mr. Neugebauer, for 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

I would like to continue along this line because one of the keys to getting private securitization going again is making sure the government is pricing its risk appropriately. And what we have seen by the fact that we had to put $200 billion in Fannie and Freddie is that they weren't pricing that risk appropriately.

So, Mr. Hughes, would you comment on the fact that—I think Redwood bonds are trading at about a 2.6 percent yield and MBS agency are trading around 2.2; I understand that there could be some differences. But that is a 40-basis point spread. And in this market, 40 basis points is real money. I would like to be getting 40 basis points on my savings. But would you kind of expand on that a little bit for us?

Mr. HUGHES. Sure. Actually, the historical average was approximately 25 basis points between those numbers. And if you rolled back the increases and guarantee fees, the actual spread today is closer to 60 basis points. What that spread was intended for was to cover three potential risks to the extent you are holding a private security: one was faster prepayments; the second was not as much liquidity; and the real biggie was the credit risk. So with the agency security didn't have that. And where the premium is today is investors needing more for that credit side, which isn't necessarily borrower credit, but it is everything that goes with the process to make sure that their investments are safe and secure.

Mr. NEUGEBAUER. Another issue that has been talked about a little bit is the fact that the agencies aren't subject to all of the same rules that the private securitizers are. And you heard me say in my opening statement about this new risk that we have in the marketplace today, this regulatory risk. How is the pricing—in other words, if the agencies today had to play by the same rules, what would be the pricing premium that would be in the marketplace for regulatory?

Mr. HUGHES. Are you referring to QM?

Mr. NEUGEBAUER. Yes.

Mr. HUGHES. Today, the pricing difference between the two markets, again, we are about three-eights of a point. To the extent that the same regulations—I think it would close the gap some, maybe an 8th of a point. But I think the bigger difference is going to have to come over time through increased guarantee fees and spreads coming in as we invite more and more investors in to the investor side.

Mr. NEUGEBAUER. Mr. Katopis?

Mr. KATOPIS. I just wanted to add an observation, Congressman, that for some of our investors, when they look at the issue you have raised very wisely, what they deem is what is the political risk premium surrounding some of the transactions in this space. Depending on the nature of the political activity, the severity that it entails, they will not—there is no premium they will pay if a 30-year contract becomes a 30-minute contract. So it depends on the nature of the activity, and it can really steer private capital out of the market.

Mr. NEUGEBAUER. I am glad you made that point. Because I think one of the things that we are hearing is, okay, even if you increase the g-fees, reduce the loan limits, create this space up there, until you bring some certainty into investor rights and servicers' responsibilities, a lot of market participants still would not be comfortable until we resolve some of the Dodd-Frank requirements—capital requirements, risk retention requirements. Does anybody disagree with that statement?

Mr. HUGHES. I totally agree with that statement.

Mr. NEUGEBAUER. What do you think would be two or three of the top impediments to us doing something quickly in that area? What would those be?

Mr. MILLSTEIN. Congressman, Representative Garrett has done a lot of work around this. And I think there are many aspects of that bill that all of us on this panel would agree with.

Mr. NEUGEBAUER. Mr. Katopis?

Mr. KATOPIS. I invite everyone to look at our testimony describing the Trust Indenture Act as an exemplary model that saved the corporate bond market in the 1930s and has worked flawlessly for the last 70 years.

Mr. NEUGEBAUER. Mr. Chairman, I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from North Carolina, Mr. Watt, for 5 minutes.

Mr. WATT. Thank you, Mr. Chairman. Thank you for convening this hearing.

Mr. Katopis, I am fascinated by some points that you made on page 11 of your written testimony in which you suggest that if we did four things—limit the charter to high-quality guarantees; ensure sound regulation with appropriate equity capital; sever government sponsorship and entity level backstops; and impose appropriate political limitations—the core mortgage guarantee business can be sold into the private markets with no government backstop and the funds realized can repay the government for sustenance, as was done with AIG. That is what you said.

I envision, then, kind of a government IPO spinning off these things, Fannie and Freddie, or at least parts of Fannie and Freddie into the private sector. And correct me if I am wrong in that vision. I would then want to know what would happen—first of all, whether that wouldn't create entities in the private sector that were too-big-to-fail and how we could guard against that?

Second, since you would be limiting this to high-quality guarantees, which is what Mr. Hughes' business sounds like it is, what, then, would you do about average-quality guarantees? And whether this could still be done with 30-year mortgages as opposed to what Dr. Kling is saying, how would you hedge against the risks that are associated with 30-year mortgages? If you could just answer that series of questions, I probably won't have enough time to ask another one.

Mr. KATOPIS. Thank you, Congressman, for the opportunity to address that issue.

I will try to answer in the time. And if we need to follow up in writing, we are happy to do so. AMI stands for a number of goals broadly, including housing finance reform, increasing housing opportunities, and bringing private capital back to the market. We believe that the GSEs can be restructured in a way where you take the "GS" off, and they are no longer government-sponsored entities and create housing opportunities. We do not promise we can do what Redwood has done with these super prime, immaculate kind of high net value homes.

Mr. WATT. You are getting me off the subject there. What I am really interested in is, it seems to me that the primary thing that the government has to sell, if we did an IPO, would be the government guarantee. And if you take that away, then you are back into a private sector with a much, much higher interest rate, I would think. Am I missing something there?

Mr. KATOPIS. Broadly speaking, and we can follow up on this, we know that the backstop creates certain characteristics for a mortgage. Those characteristics would change under this. I think it is a question of what pricing, what type of product you want to have in the market. And we certainly believe that the 30-year mortgage is valuable and is important—

Mr. WATT. For the high-end market?

Mr. KATOPIS. No.

Mr. WATT. What about for any market?

Mr. KATOPIS. For any market. It is just a matter of the characteristics would change.

Mr. WATT. One of those characteristics would be that interest rates would go up?

Mr. KATOPIS. Possibly. But, again, I think it is a question of calibrating the risk, the perceived risk by investors with the price.

Mr. WATT. And what would the government's role be at the end of the day in that process?

Mr. KATOPIS. I think the government's role, looking at the testimony of the others and our internal thinking, although we do not have an official position how to structure it, it would be very much like the FDIC, some type of insurance vehicle, just like we have for savings.

Mr. WATT. Mr. Millstein, if you can use the rest of the time analyzing what we just talked about, that would be helpful.

Mr. MILLSTEIN. Yes. I think in my materials, in an appendix, there is a chart on page 4 of the—if any of you have it, which I would just point you to, which shows you who bears mortgage credit risk today and the evolution of who bears mortgage credit risk over the last 40 years. And what you will see in the middle is a huge yellow swath where 50 percent of that credit risk has been residing with the government.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from California, Mr. Campbell, for 5 minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman. Do you want to finish that thought, Mr. Millstein?

Mr. MILLSTEIN. I do. My point is that I think we can evolve to a market where less than 50 percent of the credit risk is borne by the Federal Government. But for the last 20 years, we have had a system in which the Federal Government has borne 50 percent of the credit risk in the market. It is going to take time to bring private capital back into taking credit risks. And if you look at, on this chart, who has borne credit risk, it is the banking system, which, as we all know, was the most recent beneficiary of the massive bailout from the Federal Government when its mortgage assets were impaired.

So I think the notion that the Federal Government is just going to walk away and private investors are going to bear all the credit risks in the system is a dangerous notion. It is going to take time to evolve this. And the market—just to finish the thought—what we had suggested as a way to protect taxpayers for its guarantee is not to do it as it has been done, on an implicit basis without a fee, but to do it with lots of private capital ahead of the government as a reinsurer for an explicit fee that is well-priced.

Mr. CAMPBELL. Let me ask two questions following up on that. One is, we have been talking about the g-fee, and I keep hearing that FHA is close to market. And I guess market would be—everyone defines what is market for a government guarantee. But I guess it would be where at some point, there are some investors that say, you know what, for that margin, I will take that risk. I don't want to pay the government to do that. How close is the FHA's current g-fee to that, and also for the GSEs?

Mr. MILLSTEIN. I will let Mr. Hughes answer that. My answer to that is, today, the government is not required—there is no hurdle rate on the government's equity support for the GSE. So there is no built-in return on equity. And as a result, that margin is missing at least in the g-fee. I would say that other 15 basis points. They are an average today of about 50 basis points for the newly issued MBS. It has to get closer to 65, 75 basis points to be a market fee for that risk.

Mr. CAMPBELL. Mr. Hughes?

Mr. HUGHES. I would agree with that. And two things need to happen. One is the g-fee going up. But we also need active investors coming in, such that that spread we talked about comes in.

Mr. CAMPBELL. Right.

Mr. HUGHES. The combination of those two, and I would agree, probably 15 basis points and a combination of investors coming in would make the private sector—

Mr. CAMPBELL. Let me ask you another question about phasing the government involvement out. If you were to do it by reducing how much LTV, if you will, loan to value, that the government will guarantee—arguably, right now, FHA will guarantee up to 97 percent. Right? If you reduce that and it got—at what point does it become effectively no guarantee? In other words, if it was 65 percent, then you are talking about a 2007, 2008 crash really—the government doesn't even step in then. What is the point that you reduce and say, all right, the government will guarantee 80 percent, 75 percent, at what point does it become, as far as the market is concerned, not of any value?

Mr. MILLSTEIN. Mr. Hughes is doing deals today without a government guarantee with a 40 percent equity cushion ahead of the senior note.

Mr. CAMPBELL. Okay. So is that where it is, then, 60—if the government says, hey, we will guarantee up to 60 percent, that is—markets won't care.

Okay. In my last minute, I do want to get back to the eminent domain issue. Because in the proposals that I have in front of me, the investors take a huge haircut. The government guarantee takes a hit. And when we say investors, remember, we are talking about a lot of pension funds, 401Ks, life insurance, stuff like that. The city gets a 5 percent cut. So they get a nice 5 percent cut, and then it is refinanced with FHA. So the Federal taxpayer basically guarantees so the city can get a 5 percent cut, and then the venture capital fund that is involved with this gets $4,500, which is why they are pushing the heck out of this thing. Does anybody on this panel think that is a good idea?

Mr. HUGHES. No.

Mr. CAMPBELL. Let the record show nobody thinks it is a good idea.

If cities start doing this, what effect is that going to have in the mortgage market on private capital, on even government involvement with mortgages that exist today?

Mr. KATOPIS. Again, the political risk of having this further nationalization from local communities and cities would chill private investment and could lead to a stop of lending in certain areas, certain States. It is very troubling, and we are happy to follow up offline about any questions that any of you or your colleagues have.

Mr. CAMPBELL. Mr. Hughes?

Mr. HUGHES. I think it would be catastrophic if en masse, we were going through eminent domain. I lose sleep over a lot of things, but that is not one of them. I think there is an easy solution for that. And that would be through SIFMA, that to the extent a city decided to go ahead with eminent domain, they could stop accepting loans from that city that would fall into securities. And I think that would take care of it. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes and apologizes to the gentlelady from New York, who, on the front row, is out of sight but never out of mind. She is recognized for 5 minutes.

Mrs. MALONEY. Thank you very much, Mr. Chairman.

And I thank all of you for your excellent testimony. But all of us listen to our constituents. And what I am hearing from my constituents is that even if they have an excellent credit rating and scores, they can't get a mortgage or have tremendous difficulty getting a mortgage, or have tremendous difficulty refinancing. And so, I think that the role that Fannie and Freddie has played during this crisis under government conservatorship is that they have played a role in getting the system moving.

So my question to all of you, and I would like to just go down the line, starting with you, Mr. Chris Katopis, do you think that the private market is ready to take the credit risk in the size that Fannie and Freddie are bearing? And I would like a detailed answer from each of you. Because that is the critical issue that is before us today.

Mr. KATOPIS. Congresswoman, I think that investors are very good at pricing risk when they have the information. For them to step into the situation you have described, they would need a lot more transparency, a lot more effective remedies, and the other issues that I have outlined in testimony where they could step in. Ultimately, as has been described, there is a lot of liquidity in the market. But there would be an incremental process if those legal protections and transparency are available for investors.

Mr. HUGHES. Certainly, the private sector today is not ready to step in and replace Fannie Mae and Freddie Mac. What we do think the private sector could do is provide on a risk-sharing basis, take the credit risk on a number of pools today.

In terms of the private sector, one of the things we are looking for, we had to start with the best of credit to get investors back. But we would look to expand that box over time, where it would be people who are good credit for exactly the reasons that you are saying to provide and widen the box today.

Mr. MILLSTEIN. At its height, the private label securitization market in 2006 did $750 billion of issuance that year. This last year, 2012, we did $1.9 trillion of issuance of new mortgage originations or refinancings. So at its height, it was about 40 percent of the market today. I think credit investors will come back. But the idea that they can replace Fannie and Freddie any time soon, I think is fanciful.

Mr. KLING. I guess my hope is actually that old-fashioned banks and savings and loans could replace Freddie Mac and Fannie Mae. It might take them awhile to gear up operationally, and the regulators might have to make it reasonably attractive for them to hold mortgage loans, not penalize them, as they have in the past, for holding mortgage loans. But there is a lot to be said for it. As I hear the problems of investors and servicers, I think if you hold the mortgage the way that savings and loans used to hold it, you don't have to worry about your contractual relationship between the investor and the servicer. It is the same person, the same institution. So just consider that as one possible way of bringing private capital—of getting the credit risks into the private sector might be the old-fashioned banks and savings and loans.

Mr. MILLSTEIN. Can I respond to that? One of the great financial innovations in America in the 1980s was the creation of securitization markets. It enabled pension funds and insurance companies which have long-term liabilities they need to fund to access the long-term mortgage market. And it was a proper matching of assets and liabilities in the system, and it helped, as you see from that chart on page 4, take mortgage credit risk out of the banking system, which collapsed in the 1930s as a result of the risk that it bore.

There is something fundamentally really good about the securitization business because it diversifies credit risk. The question is how to do it in a sensible, rational way that protects taxpayers. Because right now, and for the last 20 years, 50 percent of the credit risk in the security—that the securitization market is bearing is really in the Federal Government, and it is going to take time to wean the market off that.

Mrs. MALONEY. All of the Congress, Mr. Chairman, and my colleagues have testified that the private market is not ready to come in and assume this role, which is critical to our overall financial stability and the growth of our economy. My time has expired.

Chairman HENSARLING. The time of the gentlelady has expired. The Chair now recognizes the gentleman from Missouri, Mr. Luetkemeyer, for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Mr. Millstein, in your—there is an article we have access to that you had in the Washington Post on October 12, 2012. And in there, you made a statement something to the effect of we are transforming Fannie and Freddie into more of an insurance company versus the entities that they are now, at least that is kind of the way I take it. Am I misreading that?

Mr. MILLSTEIN. They are insurers today. They basically provide a guarantee of principal and interest on mortgage-backed securities. But they do it with—it used to be an implied government guarantee. Now, it is an express guarantee.

Mr. LUETKEMEYER. But you are going to basically transform them into a different entity?

Mr. MILLSTEIN. That is right. We are going to take the—what we propose to do is to take the private—sorry—the mortgage guarantee business that provides that insurance to investors and privatize it and privatize it with an appropriate level of capital to back those guarantees.

Mr. LUETKEMEYER. And that would be a private entity, then, or is it going to be a government entity?

Mr. MILLSTEIN. There would be private entities, and they would be able to buy reinsurance from the government for a fee.

Mr. LUETKEMEYER. Okay. I just want to follow up on the eminent domain question that the gentleman from California had.

Mr. Katopis, in your testimony, there is quite a bit of discussion about that. Would you like to elaborate on that? I think that is something a lot of us on the committee probably haven't had a lot of exposure to, but I have had one of my major cities in my district, just outside my district actually go through this exercise, and it was rejected by the citizens of the city. But it certainly scared the financial community in my State because of the potential that could happen with this.

Mr. KATOPIS. It is a proposal, as we understand, being developed by an investment company. It is not a charitable organization. And the idea is to do a short—massive short refi in a way that would take performing underwater mortgages, refinance them, and give the local community a cut of the action. We think that it is an idea that has—it is untried. Its constitutionality is dubious. I know that different communities, in response to the Kelo decision a number of years ago, have changed their laws. So it really can't be implemented in a lot of jurisdictions. But it is troubling. We don't really know the contours of the proposal. The company that is pursuing this, it is like, "Let's Make a Deal." They are constantly changing, upping the fee for the community to entice them. And it raises a lot of issues, including the liability to the community or the State should the valuations be off.

So I think at the end of the day, we have to ask, is it a solution to a real problem. And when we look at some of these underwater performing mortgages, we have people who have been paying their mortgage for the last 12 to 72 months. So we understand that they may have some anxiety, but they are not necessarily at risk. And a number of them, when you do the research, they are underwater because they did cashout refi's. We did analysis with an analyst for one of the California communities, and 50 percent of his mortgages were cashout refi's. So they really weren't underwater; the equity was recapitalized—reconstituted in some way. So that is troubling.

Are you bailing out people who—while your neighbor paid their mortgage diligently for the last 72 months, you did a refi, cash out, bought a BMW, bought a plasma TV, did something else? So I think you really have to look at what is trying to be achieved as part of this process, where are the consequences to the community if the legality—

Mr. LUETKEMEYER. Do they undermine the lienholder position of the financial institution here with what they are doing?

Mr. KATOPIS. It certainly poses a risk to institutions because it—again, who owns a lot of these securities and mortgages, some of them are by community banks; some are them are by State pension funds. So, there really are a lot of questions.

Mr. LUETKEMEYER. That is where the concern is, that there is a gray line that has been established there, which is like, holy smokes, this goes against the—

Mr. KATOPIS. The fundamental question seems to be how to help responsible homeowners who are hurting. And there are a number of tools that are available. I think that eminent domain is a drastic solution, and it is not something that should be pursued.

Mr. LUETKEMEYER. I just have a few seconds left. I want to follow up on a couple of questions. I know that one of the other panelists asked about the QM, QRM securitization problems. Does that—are those rules going to impact you? Basel III, how is that going to affect to be able to securitize loans and the options of going to the market, private market folks?

Mr. HUGHES. Clearly, one of the key things under Dodd-Frank that needs to get done is the definition of QRM, which I think is a good starting point, for it would be QM. But I think if we go through look the eyes of investors, QM alone is not enough to find a safe mortgage for investors.

Mr. LUETKEMEYER. Is that a deal-breaker if we don't do that?

Mr. HUGHES. If you—the same—to me, QM, if you are protecting investors, needs to go beyond just—it needs full documentation. It needs loan to value. There needs to be a downpayment requirement of some size.

Chairman HENSARLING. Regrettably, the time of the gentleman has expired.

The Chair recognizes the gentleman from New York, Mr. Meeks, for 5 minutes.

Mr. MEEKS. Thank you, Mr. Chairman.

There are a number of issues, so much to try to get through in 5 minutes. I am concerned also about QRM and 20 percent and seeing whether or not that would make it almost impossible for some average American citizens to own a home, whether that is too high. You are taking into consideration the whole individual and their ability to pay, which I think is very important. So that debate—I know that we need to have some finalization in what the rule will be. But the question is, is it 20 percent? Is it 10 percent? Is it 5 percent? What is best, as far as making sure of being as sure as you possibly can that an individual—that we are not closing out a whole segment of the American people from the possibility of owning a home. But I heard, Mr. Hughes, you saying 20 percent, you thought that 20 percent is where it should be. And so, therefore, a number of Americans should not be eligible to buy a home. Is that what you said?

Mr. HUGHES. No, that is not what I said or not what I intended to say. I would say for the part of the market that is going to be financed through the private sector, yes, I think they are going to need a downpayment. And whether that is 10 percent or 20 percent, it is going to need something. I think that is why we are going to have other parts of the mortgage finance market that will be at the discretion of the government here to provide financing. But, again, my lens today is what is it going to take to get the one segment out there back, which is the private sector side of it?

Mr. MEEKS. Mr. Millstein, would you comment on that?

Mr. MILLSTEIN. Yes. I think the risk potential requirements—right now, the QM effectively carves out the government sector for a limited period of time. Because I think the regulators themselves need to know where FHA and where Fannie and Freddie are going in order to actually create a comprehensive regulation here. So I think the concern you express is one that is real, but I don't think the regulators yet have come down in a way that is definitively something that you would oppose because, in fact, I think they are all waiting for Congress and the Administration to tell them what is the fate of the FHA and Fannie and Freddie, who are currently carved out?

Mr. MEEKS. I have a question, but I wanted to get to another area really quick, because I have real concerns during the lead up to the 2008 financial crisis, and that was dealing with the credit rating agencies. We know that a significant number of investors relied exclusively on the rating agencies' evaluation of private label securities to inform the investors of their decision, and later, those ratings turned out to be completely inaccurate and the Wall Street Reform Act included several provisions aimed at improving the investor's ability to understand how the rating agencies reviewed securities as well as provide a specific private right of action against rating agencies. So, given the failure to perform due diligence in its review of private label securities prior to the financial crisis, what role, if any, do you think that the credit agencies will play in the market going forward?

Mr. HUGHES. Right now, most of the financial system and major investment firms as part of their asset criteria on what you can buy, the incentive is on the private side which requires a rating agency AAA rating. In many cases, it is two. So I think for the time being, and we are dealing with the rating agencies now, it is going to be required on the private side so there is a benchmark that the rating agencies' AAA rating would be very important.

Mr. MEEKS. Do you think that the credit rating agency reforms that were included in Dodd-Frank, the Wall Street Reform Act, restore any confidence in the use of these credit ratings? Do you think there are any additional reforms that are needed to improve the ratings industry?

Mr. MILLSTEIN. Dodd-Frank is one of the great unresolved problems from the crisis—what to do with the rating agencies? We all want something other than them embedded in the system. But insurance company asset rating—I am sorry—capital ratios are still dependent on rating, as are banks. We haven't gotten rid of them. What we can do and what the reforms that we have talked about on the panel today and that a number of bills that have been introduced address is create much greater transparency in the pools so investors could do their home work.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Ohio, Mr. Stivers, for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman.

I appreciate you holding this important hearing. And I appreciate all the witnesses for being here.

I was struck by something the gentlelady from New York said earlier about how the market is not ready for privatization. And clearly, that is true. But if Congress does nothing, the market will never be ready. I was struck by the things that Mr. Hughes and Mr. Millstein both said about a plan for a gradual transition to a private market. Assuming Congress does some of the things that were in both of your testimonies, how long would it be before we could get to a private market? I will let both Mr. Hughes and Mr. Millstein answer that one.

Mr. MILLSTEIN. So, again, I would direct you to page 4. Just that slide. It took 20 years for the government sector to get this big as the savings and loans effectively went out of this business, in large part. I think this transition could be at least that long. That doesn't mean you don't start. But it means you have to be prudent in—

Mr. STIVERS. If you don't start, how long will it take?

Mr. MILLSTEIN. It will never happen.

Mr. STIVERS. Exactly.

Mr. Hughes?

Mr. HUGHES. Markets need room to grow. Markets grow when there are active buyers and sellers, when there is a need. Unless you create a need and break the status quo, I don't see how the markets are going to come back, given the opportunity, and just do it on a safe and measured basis.

Mr. STIVERS. Thank you.

And to something Mr. Millstein said, Mr. Kling, because you talked about it earlier. We all talk about community banks and how important they are to our communities. Do you think that allowing and encouraging community banks to have an originate and hold strategy, what my grandfather did before—my father ran a community bank and they started securitizing. But my grandfather originated and held those loans to term until they were paid off. Do you think that helps create a role for community banks in leveraging the capital that is in community banks to help transition to a private market?

Mr. Kling?

Mr. KLING. Let me repeat, all the money in the mortgage market today comes from the private sector. It is just that the risk, the credit risk is being absorbed by taxpayers. As taxpayers absorb less credit risk, then the prices will adjust, the suppliers will adjust, the intermediaries will adjust. Community banks can be suppliers, and so can national banks. The money is sitting out there. As an investor, I don't care whether my money goes to a money market fund or a mutual fund that invests in mortgage securities or whether my money goes into a bank CD. That is not the issue.

The issue is, who is going to bear the credit risk? And if the taxpayers gradually back off of bearing the credit risk, other intermediaries—and we can't necessarily dictate which ones, although some people would like to—will come in to take that credit risk.

Mr. MILLSTEIN. A little comment on the community banks: When you think about a small bank, the question is, where does it get funding? Deposits are the clear primary source. But if you don't give these banks access to the secondary market, they are significantly disadvantaged in competition with the large banks. And one of the really great features of the Fannies and Freddies of the world is their ability to give community banks access to funding sources in the secondary market. So, again, if you take that away, if that is no longer part of the—

Mr. STIVERS. Although most of our community banks use the Federal home loan model ahead of the GSE model.

Mr. MILLSTEIN. Ahead of it, but not in full replacement of it. Because, ultimately, the GSEs provide these guys funding that the big banks have access to. They can float bonds, they have access to the capital markets directly. The community banks rely on these intermediaries, Fannie and Freddie.

Mr. STIVERS. Sure.

Mr. Hughes, Mr. Luetkemeyer talked originally about Basel III, but I don't think you got a chance to answer what the impact of that will be on the future of private capital return to the market.

Mr. HUGHES. I am not the right guy to ask about Basel III.

Mr. STIVERS. Sorry. Maybe Mr. Millstein?

Mr. MILLSTEIN. It is going to force all banking entities to hold more capital against these assets. Again, one of the great lessons of the crisis was that almost everybody—banks, community banks, Fannie and Freddie—who held mortgage risk did not have enough capital against it. So from a point of view of financial stability, making sure the system is not undercapitalized is a key feature of reform.

Mr. STIVERS. Mr. Chairman, I would like to enter into the record a couple of pieces of documentation. One is from the former CBO Director, Douglas Holtz-Eakin, that is a study about Basel III and DFA rules and what they would mean. And it suggests it would mean 3.9 percent fewer jobs and 1.1 percent—

Chairman HENSARLING. Without objection, it is so ordered.

Mr. STIVERS. Thank you. I yield back the balance of my nonexistent time.

Chairman HENSARLING. There is no time to yield back.

The Chair recognizes the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman.

I have to tell you, I am worried about the little fellow in this. And it seems to me that is the undercurrent of the question we need to raise here in terms of impact. There is a reason, as I said in my opening statement, for the GSEs. There clearly are certain things that the private sector is not going to respond to. And it is very important for the private sector to examine these. So as we examine the regulatory impediments to the private investment capital coming in, we also need to examine the culture of the private sector. There is a reason for both here.

Let me give you an example. I have home foreclosure events in my area. I come out of Georgia, the metro area of Atlanta, which has one of the highest foreclosure rates; they are underwater. And every time I have one of these events, we have representatives of Federal programs there to assist some of these homeowners. One was HAMP. And the only—when I talk to the banks, when I talk to those homeowners, and I say, why won't you use HAMP for this? They say, we will only use HAMP if that mortgage is backed by Fannie or Freddie. So the question becomes, if we phase Fannie and Freddie out, what happens there?

And so I think that what we have here is sort of like a square peg we are trying to fit into a round hole.

I believe that having 90 percent of these mortgages backed by the government is not healthy for us, no doubt about it. But I think as we go forward, it shouldn't be this or that, but maybe a combination here. And I think it is very important that each of the four of you have come to the conclusion, I believe, that you are aware that the private capital and the private investors cannot come in and replace Fannie.

Can we agree that is a statement here?

All right. Moving forward, what I understand we should do here is to come up with a way in which we could deal with this. And I think you mentioned, Mr. Katopis, something called the Trust Indenture Act as a model that was done back then that we need to work to.

And, Mr. Millstein, I think you dealt with the guarantee fee, of how we can manipulate that to—as two levers.

So can each of you kind of explain going forward how that would work as a way of easing in private capital and yet being sensitive to the safety net value of Fannie and Freddie?

Mr. KATOPIS. Thank you, Congressman.

I just want to make some brief observations. And I invite you to see the testimony where we say that since the financial crisis, the amount of capital available in the system is at an all-time low. So I think the conversation has to be about not only the people who need assistance, who are hurting and are looking to HAMP and HARP as vehicles for assistance, as well as the other dozen Federal programs and other State assistance programs, but how do we help the first-time homeowner, the person coming into the system, maybe just graduating from a college in Georgia, who are looking to buy their first home, or the veteran, how do we help them?

We need to have a system where private capital comes into the market. Because as I mentioned in my opening statement, the mortgage system is about private capital investors to borrowers and back. So the Trust and Indenture Act is a system—you know what it is? It is an investor bill of rights and a bank originator quality control measure. And it is detailed in our testimony. We think that it will set the rules of the road, create standards in the systems that will allow that private capital to come back for both people who need refinancing and new homeowners.

Mr. SCOTT. Mr. Millstein, very quickly, could you tell us about the guarantee fees? To what extent do guarantee fees that are charged by Fannie and Freddie need to rise in order to bring in private capital?

Mr. MILLSTEIN. As I said earlier today, Fannie and Freddie are not being required to earn a return on capital. Government is providing its capital effectively without requiring the entities to earn a return on it. If they were to have private enterprise-like capital return on equity hurdles, they would probably have to raise the g-fees another 15 basis points.

Mr. GARRETT [presiding]. I thank the gentleman for the answer.

The gentleman from South Carolina, Mr. Mulvaney, is recognized now for 5 minutes.

Mr. MULVANEY. Thank you, Mr. Chairman. I have enjoyed the opportunity to have this hearing. So thank you for calling it.

Thank you for coming, gentlemen.

I want to focus on some smaller steps. I know we have had some discussion about some large ideas and some large plans for possibly reforming these entities. I want to start with something relatively simple that I can get my hands around, which is the fees.

Mr. Millstein, you had mentioned in your testimony, I think, that you had encouraged a program whereby fees would be properly calibrated to cover taxpayers against risk of loss. I guess my question to you is, is that really possible? If, so what, would it look like?

Mr. MILLSTEIN. Just because individuals go into the government, it doesn't mean they lose their ability to do credit ratings and credit analysis. In this last crisis, obviously, everyone in the private sector got it wrong. Banks took it on the chin; private investors took it on the chin. There was lots of bad underwriting and credit analysis that went on, not only in the government in its oversight of Fannie and Freddie but in all of the major financial institutions. So the point is, is that we can impose on the government-sponsored entity or the government reinsured entity, in my universe, a requirement to charge fees that are proper to the risk they are taking and for a government reinsurer to charge fees calibrated to the risk they are taking. And I will tell you that we have done some modeling with some of our friends on Wall Street, and we think that the government needs to charge for a reinsurance; it needs to charge 6 to 10 basis points for the privilege of providing that catastrophic guarantee. But you don't—and it doesn't have to charge more than that because you need to have a well-capitalized first-loss insurer ahead of you. If you don't have somebody who is well-capitalized ahead of you, you have to charge an awful lot more.

Mr. MULVANEY. Mr. Katopis took the position that fees by themselves are probably not enough to level the playing field to encourage private capital into the market.

Mr. Millstein, would you agree with that?

Mr. MILLSTEIN. I'm sorry, sir?

Mr. MULVANEY. Mr. Katopis stated in his testimony that he thought raising the fees might be something we should look at and should encourage. But that by itself would not be enough. Do you agree with that?

Mr. MILLSTEIN. No. I agree with that for the reasons that he cited, which is that when you look back at private label securitization market and the period 2007–2008 and then the aftermath of the crisis, it was clear that the legal protections of investors were inadequate to protect them against conflicts with second lienholders, inadequate to protect them against conflict with servicers, and inadequate to get their trustees in these trusts to actually enforce their rights.

Mr. MULVANEY. Let's talk about another tool, then, if fees aren't enough, and we all agree that fees are not enough. Let's look at the lending limits. I was struck by something that my colleague from Georgia just said, which is he is interested in how we treat the little fellow. I happen to agree with that. In fact, that is one of the original missions of these entities. The lending limit in Chester County, South Carolina, is $417,000. I have news for you; I don't think you can buy a house in Chester County, South Carolina, for $417,000. We are covering much more than just the little fellow.

What I am hearing from you, Mr. Hughes, is that there is a functioning private market above jumbo, or in the jumbo realm right now. And if we slowly were to lower those lending limits below $417,000, we may well still be able to deal with the folks that Mr. Scott and I are so interested in, but still allow private capital to enter the market below $417,000. Am I wrong about that? What am I missing?

Mr. HUGHES. I would agree. If we look back and went back to the OFHEO model, which was calibrated based on changes in home prices, if we went back to what the loan limit would have been under those models, where Fannie and Freddie would transact, the loan limit would be about $330,000 today. So, yes, I think on a safe basis, one of the ways to bring the private sector in would be to guarantee fees and give an opportunity to open up more of the market to the private sector.

Mr. MILLSTEIN. But don't go there too fast, because if you lowered it in your county to 3—whatever it is—30, the people between $330,000 and above would have to have a 40 percent downpayment for Mr. Hughes' firm to actually finance them.

Mr. HUGHES. It is not 40 percent, for the record.

Mr. MILLSTEIN. Thirty-five.

Mr. HUGHES. It is not 35 percent.

Mr. MILLSTEIN. Isn't that the average LTV?

Mr. MULVANEY. Thank you for that, gentlemen.

One unrelated question, because I heard something from you, Dr. Kling, that grabbed my attention. And I don't know the answer. At the risk of asking a question I don't know the answer to, you said that taxpayers were taking interest rate risk in ways that no one anticipated. What type of interest rate are we taking that we didn't anticipate?

Mr. KLING. Freddie and Fannie used a huge book of derivatives to hedge their risk. We don't know ultimately who is holding those derivatives, just as we didn't know that AIG was holding a lot of the credit risk before. So if there had been an interest rate spike, there would have somewhere in the shadow banking system, somebody who would have taken a big hit and we could have faced that problem.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Missouri, Mr. Cleaver, for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

I think it was Warren Buffett, I am not sure—I don't think I missed a single meeting when we were dealing with Dodd-Frank. So I think people began to quote Warren Buffett with the whole deal of declaring that we needed to—in Section 941, need to make sure that people had "skin in the game," in terms of securitization, because where I grew up, we said, "dog in the fight." But we don't have as much money as Mr. Buffett, so we said "dogs."

But my concern is, in this Section 941 of Dodd-Frank, the skin in the game requirement would require that securitizers retain 5 percent interest in the securitization. And given that the risk retention proposal provides significant flexibility, how does the proposal impact the asset-backed security market, or does it?

Mr. Millstein?

Mr. MILLSTEIN. Interestingly, Mr. Hughes will tell you that his investors require him to have skin in the game. And he had skin in the game, actually greater than 5 percent. He is taking that subordinated tranche in his pools to himself. Right?

Mr. HUGHES. Correct.

Mr. MILLSTEIN. So the market has sort of—at least as the market is today, a very small private label securitization market but growing, has actually adopted this requirement and requires the securitizer to have the junior tranche taking first loss ahead of the senior creditors.

Mr. CLEAVER. Now, Fannie and Freddie, 100 percent. Correct?

Mr. MILLSTEIN. Yes, that is right. They have skin in the game, but they don't have any capital to back it.

Mr. CLEAVER. So they don't have to retain 5 percent, correct?

Mr. MILLSTEIN. They have been carved out by Congress—sorry, by the regulators, not by Congress.

Mr. CLEAVER. Do you think that will limit the private security market?

Mr. MILLSTEIN. Yes.

Mr. CLEAVER. How so?

Mr. MILLSTEIN. I think if Fannie and Freddie are to persist, either in government-sponsored form or in privatized form, we are going to have to build into—we are going to have to let them have capital, first, to protect taxpayers against loss in either system, a cushion to absorb losses, and they are going to have to have skin in the game.

Mr. CLEAVER. Yes—anybody else? Mr. Hughes?

Mr. HUGHES. Yes. I would just like to clarify a couple of things. One, investors haven't sat there and pounded the table, Redwood, you need to hold 5 percent. We hold it as part of our business model to show alignment of interests with investors.

And second, in terms of the GSEs, I think another interesting model underfoot, rather than the GSEs having dollar one of loss through dollar 100 is to sell to the private sector, have them invest in the first tranche or the first credit loss of the securities that they are issuing, I think is a very interesting model.

Mr. CLEAVER. Yes, sir.

Mr. KATOPIS. Congressman, AMI's position is that the best skin in the game is effective reps and warranties that can be followed up in court. Certainly, if you buy anything in America, you buy an iPod, you buy a car, you get a warranty. If your State, your union is investing in mortgage-backed securities, they should have some recourse. So we would hope that effective reps and warranties are part of any future system.

Mr. CLEAVER. Mr. Kling, do you agree with everyone else?

Mr. KLING. I am just not sure that the best place to design the allocation of risk is with a government agency. When I was with Freddie Mac, we had all sorts of systems in place for dealing with what we thought were ultimately scum bags as lenders. And—

Mr. CLEAVER. Let's not get technical, sir.

Mr. KLING. And some of it was saying, well, since we don't trust you, you are going to have to sell your loan through somebody else. There are all these issues. I just think that if you try to have a government agency dictate the process by which you manage the whole loan origination to securitization process, there are going to be mistakes of both kinds, mistakes of allowing risky processes that you shouldn't allow and maybe adding to costs unnecessarily.

Mr. CLEAVER. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from New Jersey, Mr. Garrett, for 5 minutes.

Mr. GARRETT. Thank you, Mr. Chairman, and thank you to the panel.

When we talk about private securitization and you talk about investors, the investors class, all investors, I guess, are not created equal or are not similarly situated. Is that correct, in the sense that some are looking for long-term investment and some are looking for short term? I see, Mr. Hughes, you are on the button.

Mr. HUGHES. Correct.

Mr. GARRETT. Okay. So, then, if that is the case, going back to you, can you tell us, were you able to structure some of your deals in a way that you are cognizant of the fact that investors are looking for either short or long term, and so you are able to adjust or modify the cash flow in accordance with that? Yes, exactly. For some of our transactions, one of the things you can do is to take the AAA tranche, which is a one set series of cash flows, and be able to divide that cash flow up to meet the needs of different investors. So you could be an investor. And it is a zero-sum game, but you could be an investor that has a short duration that says, I am willing to accept a lower yield, but I would like my money first. You can trade somebody in the middle, and you may have an insurance company on the back end that says, fine, I want the highest yield, I feel comfortable with this, and take their money last. But, yes.

Mr. GARRETT. Okay. And so, there is a lot of talk about trying to make sure that whatever we do, we end up, at the end of the day, with a 30-year instrument that is out there. Right? So is there a—well, let's turn it around. By barring prepayment penalties, is that something that gets in the way of providing for a 30-year fixed without a wrapper on it?

Mr. HUGHES. Excuse me. I didn't quite understand.

Mr. GARRETT. All right. So if you want to establish a 30-year fixed in the market, in the private sector, without a wrap, without a guarantee, if that is the goal, do prepayment penalties help or hurt the situation?

Mr. HUGHES. I think prepayment penalties would help the situation, knowing that the duration of the cash flows would be longer.

Mr. GARRETT. Right.

Mr. HUGHES. 3 or 5 years.

Mr. GARRETT. Spend 30 seconds explaining why prepayment penalties or the borrower on prepayment penalties is adverse to an investor's interest, or could be adverse to an investor's interest?

Mr. HUGHES. It could be on the agency side as well as the private side, to the extent that you pay a premium for a security and a yield, to the extent that you paid, not par but you paid 102, with an expectation that you are going to get a higher yield, and that higher yield will last for a longer period of time. To the extent that it gets prepaid in 6 months, you are going to end up losing money on that investment. So matching the duration of the expectations for what premiums you are paying and your expectation.

Mr. GARRETT. But those are interest rate risk variations that you have, there. That if you thought you had—as an investor, you thought you had a 30-year instrument there and all of a sudden, like I say, 6 months later, because the markets have changed and now I can refinance my mortgage, I am going to do that, it is good for the homeowner, but may not be good for the investor. Right?

Mr. HUGHES. Correct.

Mr. GARRETT. So if we can adjust that and allow that to be a variable, it could actually help getting a 30-year fixed in this market.

Mr. HUGHES. Yes, it could.

Mr. GARRETT. Are there other factors that we could look at, standardization, as such, to get a TBA market and a forward-looking market to make sure that we end up with a 30-year fixed?

Mr. HUGHES. Yes. And I think your bill would go a long way toward trying to get us there.

Mr. GARRETT. That is nice to hear, sir.

Mr. HUGHES. I would say that standardization, at least as a guide, one of the things I think would be very helpful for private investors is one of the things, and this has happened over the last month-and-a-half, going through documents that are incredibly dense to try and figure out differences in private deals. I think one thing that would be very helpful is to have an industry best practices, top to bottom from seconds, whatever, and make that clearly identifiable in a prospectus so an investor can clearly see which ones agree with best practices and which ones have deviations.

Mr. GARRETT. That is pretty neat. So what would happen today or tomorrow, for example, if FHFA said, we are going to issue two pools of securities for sale, right? One over here is just what have all the standardization that you just described which FHA currently does, right, and has the wrap or the guarantee around it and another pool identical to it in all ways that you can. Would there be—obviously, there is interest in the first. Is there any interest if that were to happen tomorrow by some investors depending on the price? The price would be different, correct?

Mr. HUGHES. The price would be different.

Mr. GARRETT. Okay. So there would be—for some investors, they may find an interest in that. Do you know, could anybody—

Mr. HUGHES. I think the key thing is that what investors want is clear transparency so they know what they are buying, and if the expectations of PSA look this way and if there are deviations to it, what they just don't want to have to do is go to page 130 to figure it out. They would like on the front page to know, here are the deviations, and make true transparency and make it simple.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from California, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman.

It was interesting hearing from Mr. Mulvaney. When he used the phrase, "You couldn't find a home in Chester County for $417,000," I thought his area was like mine, that you couldn't find a home in that county for as little as $417,000. It took Mr. Watt's translation ability to tell me that, no, you couldn't find a home in his county that sold for as much as $417,000, and I think this illustrates why we need some differential in the conforming loan limit between high-cost areas and areas where homes sell for different prices.

Over the last year or so, the guarantee fees of Fannie and Freddie, the g-fees, have been raised in an attempt, among other things, to level the playing field for private capital. I wonder if the gentlemen could tell the committee if the increased g-fees have spurred your members, your organizations or others that you focus on to take the first step back into the market below the jumbo level, and if the folks are still on the sidelines when we have the guarantee fee at 50 basis points, how much higher does that guarantee fee have to go to get private capital involved below the jumbo level? It looks like Mr. Hughes is interested.

Mr. HUGHES. Yes. I would say an increase of somewhere in the neighborhood of 15 to 20 basis points would begin to get private capital back, but as I said, that has to work in concert with all the other recommendations around safety so investors know that there is safety in the investments so that the prices they are willing to pay begins to tighten, and I think the combination of investors paying at slightly tighter spreads together with higher guarantee fees would bring much more capital into the market.

Mr. SHERMAN. Now, what is stopping particularly the large banks from originating and then keeping and not even securitizing the mortgage loans? They don't have the cost of securitization. They don't have to hire a lawyer to tell them whether they have to keep 5 percent of it or not because they would be keeping the whole thing; they are not paying. There is no guarantee fee to pay, and banks have the lowest cost of capital in, certainly in my memory. So what is keeping banks from just doing what they used to do in ancient times, and that is loan money and collect payments from the borrower?

Mr. HUGHES. There are many banks today, some of the major banks with larger balance sheets that are actually holding their jumbo loans today. One of the risks out there that Dr. Kling mentioned is that the 30-year fixed, bad things happened in the S&L crisis so that people hold on their books 30-year fixed rate mortgages and their funding comes from deposits or shorter terms, you can get kind of upside down, and we had a bad chapter in our history.

Mr. SHERMAN. Yes. Is there—I realize many borrowers aren't interested in adjustable rate, but those products are still out there. Is there any real interest in the big banks holding adjustable rate mortgages?

Mr. KLING. What I heard at a conference last week is that in the jumbo market, there is a notable price differential between a 5-year adjustable and a 30-year fixed, and borrowers are willing to take the 5 year, given that price differential.

Mr. SHERMAN. Okay. The Basel III rules have raised the amount of capital banks have to hold, and as to non-government-backed mortgages with a less than 20 percent downpayment, that can be almost 50 or 100 percent more of a reserve. What effect will this have on private investment in non-government-guaranteed mortgages and mortgage-backed securities?

Mr. MILLSTEIN. That is clearly going to raise pricing. It will have an impact on banks' ability to hold those loans without higher capital charges, and it is, therefore, going to have higher pricing.

Mr. KLING. I would also just add—

Mr. SHERMAN. Yes, Mr. Kling?

Mr. KLING. The Basel agreement is really what got us where we are today.

Mr. SHERMAN. What got us—speak louder, please.

Mr. KLING. The original Basel agreement, which made AAA-rated mortgage securities cheaper for banks to hold, even if they were backed by total garbage loans, than holding a safe loan as a whole loan, and unless—so the capital requirements are a big deal in determining the nature of mortgage finance.

Mr. SHERMAN. I underlined the words AAA and realize we need reform with the credit rating agencies. I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from California, Mr. Royce, for 5 minutes.

Mr. ROYCE. Mr. Hughes, you are the only one I know right now who is involved in the private securitization market, and I remember in 2011, you made some comments that most borrowers now qualify for loans backed by government agencies, and you said one of the reasons that the private securitization market is not properly functioning is because the government is crowding out the private market through loan programs that make 90 percent of borrowers eligible for a below-market-rate government-guaranteed mortgage loan. Private capital simply cannot compete with government-subsidized mortgage programs.

You mentioned the problems that may arise from the premium capture cash reserve account provisions also in the proposed rule on Section 941 of Dodd-Frank, and going through the comment letters, you notice, we all notice that critics have noted with respect to the letters to the regulatory agency, simply speaking, this provision needs to be removed in order to prevent a material contraction in securitization activity. Certainly, it is relatively difficult to imagine a contraction in the private label mortgage market which is already severely contracted, but we seem to be doubling down here. What will this do in terms of the future viability of a private mortgage securitization market, in your opinion, if we don't get this adjusted?

Mr. HUGHES. I think it would tremendously hamper—if premium capture as written stays in there, it will hamper not only the RMBS market, it will also be the CMBS market. It is complex. I can go through it what the provisions are, but it essentially makes sure that if you are a securitizer, if you originated loans, that you are going to sell into fair market value, that you cannot make any money on that transaction.

Mr. ROYCE. You hinted earlier at interest rate policies. The Fed's quantitative easing program is having an impact on mortgage valuations and the ability, I think, for private label mortgages to be issued, but on top of all of the rest, let's go to the transparency and standardization in the market, label market, in the private label market and go to the issue of what investors are looking for. We have seen a proactive effort led by the American Securitization Forum with Project RESTART, which Acting Director DeMarco said will provide a real-time test of a new standardized contractual framework for transactions where the private sector is absorbing credit risk. So this is a good first step, I think, toward standardizing all loan level information.

How do we ensure that future issuers continue to comply with the standards—and I would ask that of any members here on the panel—set by this Project RESTART, and in a similar vein, is it possible for standardization to include information on the due diligence process being employed by new private label issuers where end users will then have full transparency of how the process works? I think it is also important which vendors are performing the due diligence. Would that be possible in terms of this transparency and consistency for investors and how much would that help?

Mr. KATOPIS. Congressman, thank you for raising these issues which are very important to AMI and its members. In summary, we share the objectives that are being stated by ASF with this Project RESTART. We are concerned that after 5 years, there has not been a result of this restart project. That is one of the reasons why AMI is here to testify today to explain that all the goals that you have mentioned—enhanced transparency, greater standardization—are things that we need the sort of light hand of government to set standards and systems for the market to move forward and private capital to return. So I think there is probably a parallel effort that needs to go on.

Mr. HUGHES. I would say also there is a balancing act because we try—we are completely transparent—to tell investors whatever we can about the loans, but that is in conflict at times with privacy, and one of the things that is in conflict with privacy would be due diligence results, street address, name, and things like that. So we need to balance privacy with transparency.

Mr. ROYCE. Thank you, Mr. Hughes.

Any other observations by other members of the panel?

Thank you, Mr. Chairman.

Chairman HENSARLING. The gentleman's time has expired. The Chair now recognizes the gentleman from Delaware, Mr. Carney, for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman.

Thank you to the panelists for coming in today. I appreciate this hearing. This is the second or third hearing we have had on housing finance reform. It has been very enlightening and interesting to me. I am not smart enough to figure out, though, some of the difficulties in transition. Each of you, I think, has warned us about transitioning to a very different system. There seems to be an emerging agreement or consensus around the fact that we need to bring more private capital in. What that looks like as an end state remains to be seen, and more importantly, how you transition to that end state.

Mr. Millstein, I haven't read your whole written statement, but we have met before, and I have listened to your proposal, and it seems very interesting and one that we ought to think about seriously. I have two concerns, or rather a question and a concern. Are you familiar with what Mr. DeMarco is doing? Are each of you familiar with what Mr. DeMarco is doing in terms of setting up a platform, I think he calls it for future securitization? Are you familiar with that, and is that consistent with any of the models that we might be moving toward?

Mr. Millstein, you are shaking your head.

Mr. MILLSTEIN. Yes, I am. It is a massive reengineering of software for both companies. They are doing it on a joint venture basis to be able to track a loan from origination into the pooling ultimately the servicing of that. So it is an important project and could create both greater transparency and a utility that other market participants could use.

Mr. CARNEY. So, in that sense, Mr. Katopis, in your piece you raise a lot of concerns about the legal structure that again I don't really understand it so much, but do we have that framework? You talk about the Trust Indenture Act as a model for what needs to be done now. Do we need to do that so that Mr. DeMarco is setting up something consistent with the new legal structure?

Mr. KATOPIS. Congressman, I think the key is what Mr. DeMarco appears to be doing is establishing a platform for agency, and we are private label, so I think his endeavor could be very valuable, especially if it was open access to all market participants, and likewise the development of something along the lines of the Trust Indenture Act provisions would be a very important complement and help private capital return to the market.

Mr. CARNEY. Do you have something specific in terms of what that model, what that Act might look like modeled after the Trust Indenture Act?

Mr. KATOPIS. We have an exemplary draft bill that we are happy to share with anyone, and come by and spend some time with you about it, so I would be happy to follow up.

Mr. CARNEY. That is great.

Mr. Millstein, back to you. This is a great graph here, and I am wondering if you could explain to us what it might look like beyond 2011 or what these—how it might transition and what might be included in the yellow and what the red might look like, and one of the things I am—the follow-up question is going to be, there was a time prior to the mid-1980s where savings and loans and credit unions had a much larger part of this market, and we know what happened at the end of that period of time, and what worries me a little bit is as we change, we invite private capital in, let's assume it all comes back in, and then something happens where they don't get it right, and if all that private capital leaves the market, then what are we left with if we don't have—what is the public role that could fill in at that point?

Mr. MILLSTEIN. Congressman, if you were to actually flip to page 10 of that, because what I want to do is explain what I think the yellow on page 4, where that yellow segment is going or should go, where I would highly recommend to you that it go.

So the old system is on the left side; this is how is the government guarantee delivered. The old system is on the left side where you have homeowner equity and Fannie and Freddie undercapitalized with very little capital required by the regulator to support the credit risks they were bearing. The current system is you have homeowner equity and private mortgage insurance and the Treasury Department is backing, it basically bears all the credit risk in the Fannie and Freddie book. The new system we propose is one where homeowner equity is first in line; then you have effectively the risk retention either by a guarantor, a private guarantor such as we would make Fannie and Freddie, or an issuer such as Redwood Trust, taking the next layer of risk. And only after those two layers would the government reinsurance kick in, only after those two layers of risk.

Mr. CARNEY. So what happens if all of a sudden the red block in the new system goes away?

Mr. MILLSTEIN. The government can tune it up to deal with, turn up the attachment point.

Mr. CARNEY. Thanks very much. My time has expired.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Florida, Mr. Ross, for 5 minutes.

Mr. ROSS. Thank you, Mr. Chairman.

Mr. Hughes, I just have to ask you, you spoke of your jumbo loans, and as I understand it, you have a robust market in the jumbo loans?

Mr. HUGHES. Yes, we do.

Mr. ROSS. At a 60 percent loan to value?

Mr. HUGHES. We are, just to correct, again, I didn't say 60 percent loan to value. Today, we are offering jumbo loans up to a million dollars for 80 percent.

Mr. ROSS. Okay. Do you put those on the secondary market afterwards, or do you hold those yourselves?

Mr. HUGHES. No, we then take those and securitize those through private securitization.

Mr. ROSS. I understand.

Mr. Katopis, you testified earlier about the inflated mortgage debt that we have out there. Would you say that there is enough private capital in terms of capacity to meet a market if a market were to come back?

Mr. KATOPIS. There are three sources of mortgage finance: banks; the Enterprises; and the private markets, PLS. There is a lot of liquidity, as has been testified about. So it can come back, provided the systems and safeguards are there, and it will increase as the Enterprises are wound down.

Mr. ROSS. So you feel that over time, there will be sufficient capacity to meet the demand? And some of the problems we have that I think you touched on were the cost of compliance, I mean the cost of regulatory compliance. If Basel III is implemented, you will have the cost of capital compliance, so that is going to further suppress any reentry of the private market, won't it?

Mr. KATOPIS. As we have testified, regulatory and legal pressures will be a head wind for private capital coming back.

Mr. ROSS. And at one time, I guess back when it was a purer system, back in the 1970s and 1980s when you had companies that would originate and hold a mortgage, and they would originate and hold a mortgage because they managed the risk. And then I think as the GSEs became more involved, you saw a lowering of standards to the point where the FICO scores didn't matter, to the point where employment didn't matter, where there was no verification of income even, and you moved to a system of, I think, what is called originate and sell. And it created this moral hazard, if you will, I think that more and more companies were trying to just originate a loan and then sell it to the secondary market, which then led to our collapse. Would you agree that there is a way maybe we can bring this back if we had originate and hold for 5 years or just—I say that 5 years arbitrarily, so that the market in and of itself would have to have some standards of risk?

Mr. KATOPIS. Thank you, Congressman.

In response to that, we would offer that effective reps and warranties as part of a standardized PSA or standardized docs would achieve the goal I think you are suggesting.

Mr. ROSS. Right.

Mr. KATOPIS. Do you want to weigh in?

Mr. HUGHES. Yes. I don't think there would be enough liquidity in the system if, in fact, people had to hold mortgages for 5 years. I think going—

Mr. ROSS. Is there a magic period of time, though?

Mr. HUGHES. I think the most important thing is for the mortgages that they produce, that they stand behind those mortgages, so that there are real reps and warrants.

Mr. ROSS. I agree. So it is truly risk-based?

Mr. HUGHES. Correct.

Mr. ROSS. Yes.

Dr. Kling, the chairman had a couple of questions about the Canadian system and the 30-year amortization with a 5 year revisiting of the interest rate. You mentioned that and I understood this to be that had we done something like that it may have caused Freddie and Fannie to go into bankruptcy. Is that correct?

Mr. KLING. No. My concern with Freddie and Fannie is that if—

Mr. ROSS. Because they essentially went into bankruptcy anyway.

Mr. KLING. Yes.

Mr. ROSS. They were in receivership, and so—

Mr. KLING. Right. My concern there is that if we go to any system where the 30-year fixed-rate mortgage is dominant, if we had—let's say Freddie and Fannie had done fine on credit risk, but somehow we had had an interest rate spike sometime in the last 5 years, I am not sure Freddie and Fannie would have been solvent. And—

Mr. ROSS. I appreciate that. I apologize, I only have a minute left and I have to go to Mr. Millstein for just one quick second. I would love to explore that with you further. Mr. Millstein, you hit on something that I think is really important. You talked about a reinsurance market being there as the guarantee, and the way I look at capital is that you have risk-based private capital, you have taxpayer-based capital, and you have debt-based capital, and the only one that really works that sends a message as to how to truly actuarially assess your risk is the private risk-based capital. You believe, then, that there is a way that reinsurance can be used to supplant the GSE system that we have today?

Mr. MILLSTEIN. I do.

Mr. ROSS. And how long do you think that would take? What incentives would it take? Is it affordable? Is it transitional? How would you suggest we get there?

Mr. MILLSTEIN. I am happy to come back and talk to you. I have a whole transition plan that we have laid out.

Mr. ROSS. I would be very interested in that.

Mr. MILLSTEIN. It takes about 3 to 5 years.

Mr. ROSS. I appreciate that.

With that, Mr. Chairman, I will yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from Maryland, Mr. Delaney, for 5 minutes.

Mr. DELANEY. Thank you, Mr. Chairman.

And thank you for this very constructive debate here today. I just had one specific question, but I wanted to set it up a little bit. It seems to me—and, Mr. Hughes, I think you touched on this—that for the private market to really get back in this business, and we should remind ourselves that the private market is also in the government business, right, because private investors buy an enormous number of agency securities, so it is really about migrating an already large pool of investors to an investment vehicle that doesn't have explicit or implicit government support, and what we need is a convergence of credit regulation and pricing to come together to make that market attractive, and of those three things, credit is the one we control the least, but unfortunately, it seems like the environment for that is actually getting pretty good as we are seeing some recovery in housing. I thought the testimony on regulations, in other words, creating certainty around the regulatory environment is critical, and I generally agree with everything that was said in that regard because I think that would help, and then finally the guarantee fees if we can—the good news here is the aspect we control the least, credit, seems to be going in the right direction. So if we could actually adjust the guarantee fees and do things with regulatory changes, it seems like we could get into a pretty good place in terms of getting the private market active.

Mr. Millstein, I think your proposal lays out a very good vision for the future of housing finance, something that has been lacking, and I think this notion of having government reinsurance that attaches to a mortgage so that mortgage could be held in any number of institutions, whether it be a bank or a securitization vehicle, is terrific provided the capital levels are the same so there is no real capital arbitrage.

But the one question I have is you talk about wanting to take what remains of Fannie and Freddie and privatize those and start retaining the earnings of those Enterprises, and I understand why that is good for the preferred stockholders, and I appreciate your disclosure that you are an investor in the preferred stock, because it is massively attractive for preferred stockholders to do that generally speaking—but that is not my question, and that is fine; that is actually not the point of my question. I worry about, as we look to privatize those Enterprises and the government has a stake in those Enterprises and we all want to do what is best for the taxpayer, I worry about the conflicts and the incentives to try to set up those institutions through some form of government support that makes that number that we sell them for as good as possible because that will look good and to some extent put in place some enterprises that permanently have a competitive advantage going forward as opposed to taking your plan and just saying we are going to have the mortgage insurance market like you described, but we are just going to have new infrastructure manage it and actually wind these things down. So why is one better than the other?

Mr. MILLSTEIN. Okay. I will tell you a cautionary tale from the 1930s. Under the Federal Housing Administration Act of 1934, they had a very similar idea to this idea, that we should create a government charter that gave you the right to access of the secondary market with a specialized government charter. And the Roosevelt Administration went to Wall Street and said, you guys should take these charters out because this will enable you to access mortgage funding cheaply that you can then provide to the primary mortgage market. No one came. They built it; nobody came. And so President Roosevelt went to the head of the Reconstruction Finance Corporation, the TARP of its day, and asked him to please set up a subsidiary and take one of these charters out, and who is that today? Fannie Mae. That is where Fannie Mae came from. So my concern is that we may build this mortgage reinsurance system, and no one will come.

We have these two entities in our hot little hands today. We can turn them into private insurers and make sure that we have someone to come with a big layer of capital ahead of us on our reinsurance to protect the taxpayers against risk on that guarantee.

Mr. DELANEY. But wouldn't they come, and maybe, Mr. Hughes, if we create the reinsurance product and have the capital levels that attach to the guaranteed part be attractive enough, wouldn't they come to that?

Mr. HUGHES. I think they would come to that, on an individual pool basis, yes, I do. I think, if Fannie and Freddie were to issue pools—there are various ways under consideration to sell that. One of the issues right now is going to be transparency, loan level information, and right now, I would think that Fannie and Freddie do not—they are working on it—have the same level of transparency which private investors would want, but I think you could get there.

Mr. DELANEY. I will close by saying, again, I like your plan quite a bit, Mr. Millstein. I just worry that by launching these two as private enterprises, we will somehow find ourselves with monopolistic businesses still in the mortgage market in some way or form, and it would be better to have that more dispersed throughout the private markets.

Mr. MILLSTEIN. You and I should discuss that.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Illinois, Mr. Hultgren, for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman.

Thank you all for being here. A few questions. First of all, Mr. Katopis, I wonder if I could address to you, we heard testimony back in March about some of the competitive advantages for the GSEs, and that FHA has compared to their private competitors. I wonder if you could elaborate on this for us and how the GSEs and FHA pricing, how are they pricing investors out of the market?

Mr. KATOPIS. I will be brief, and I would like to follow up because what I have said in the testimony that was provided is that we feel the investors are being crowded out and that there are a number of economic and noneconomic advantages that the Enterprises now have. We have discussed the g-fee issue. So, we have discussed a number of these. Some of these actually also affect the way the GSEs can impact servicing. They have certain advantages that do not exist in the private sector. Again, we would like a level competitive playing field. Our organization hasn't really looked at some of the FHA issues in detail, but I am happy to poll my members and get back to you regarding that.

Mr. HULTGREN. That would be great if we could follow back up with you, any suggestions you have.

I will move over to Mr. Hughes. I know you have touched on this in different questions and also in your own testimony, but I wonder if you could just get into more specifics on a recommendation of how we can level the playing field? We talked a little about the g-fees but tell me more about that as a potential solution and really as a way to increase investor interest in the private market.

Mr. HUGHES. Yes, I think we have to work on two fronts. I think the g-fees is one side of it that helps the mass side of it opening up more opportunity to the market, but quite frankly, the more important thing is on the structural protections, transparency, and alignment of interests because that is what investors are waiting to see. There is plenty of money out there. If we can get those pieces in place, I think it would go a long way to bringing the private sector back.

Mr. HULTGREN. On the g-fees side, I know you mentioned there is two, and the structural side is maybe the more important, but if we were to do something with the g-fee side, how high do you think that would need to go in order to be an incentive?

Mr. HUGHES. I think, again, with the combination of the private sector coming in, and spreads tightening, I would say probably somewhere around 15 to 20 basis points should make it competitive.

Mr. HULTGREN. Dr. Kling, are there other advantages Congress has given to the GSEs that we should reconsider if our desire is truly to level the playing field where public capital has no advantage over private investment?

Mr. KLING. Traditionally, there have been advantages in terms of not having to register securities, and I can't remember off the top of my head the litany of advantages that the GSEs have had, and so my suggestion is to simplify the problem by just lowering the loan limits gradually and then opening it up to the private sector that way rather than trying to figure out which of these—and above all, you have the implied guarantee and what is that worth, now the explicit guarantee.

Mr. HULTGREN. Okay. One last question, just in the last minute or a little over a minute that I have, and any of you who have a thought on this, if you could respond. The Treasury Department has advocated for gradually reducing conforming loan limits, as you have mentioned, to bring private capital back in to certain areas of the market. Is there private sector demand for loans that would fall into these elevated loan level limits? What do you think a reasonable time frame for changes like that, how gradual does it need to be? Could the market cover these changes very quickly, or would the process need to be gradual to guard against that market shock? So any thoughts you have? Again, I know, Dr. Kling, you have talked briefly on this, but any of the others?

Mr. HUGHES. I think the platform that Redwood has set up, and everything goes with that platform, from structural protections to transparency all the way through to alignment of interests, I don't see why the private sector would invest in prime loans of any size, as long as you get it together, but it has to come down in stages. But what we have built is transferrable; it is just not that the only people that we can lend to are rich people. I think it is a process and a platform that is transferrable down to lower limits.

Mr. HULTGREN. Okay. Again, thank you all. I have just a few seconds left, so I will yield the few seconds I have back to the chairman. Thank you.

Chairman HENSARLING. The Chair now recognizes the gentleman from Indiana, Mr. Stutzman, for 5 minutes.

Mr. STUTZMAN. Thank you, Mr. Chairman, and thank you for your time today in addressing this issue. I know all of us want as much capital into the market, I should say, as possible, but of course to meet the needs that we have for consumers and for a healthy economy, and I don't care which one of you all want to touch on this, but could you, with the disparity and the differences between what the GSEs' standards are—they are held to different standards since they are in receivership. What do you see as the disparity between category 1 and 2 loans due to the incentive to move more capital into the private mortgage market? Any of you?

Mr. MILLSTEIN. I am sorry—

Mr. HUGHES. I think all of us are—a definition of category 1 and 2 would be helpful.

Mr. STUTZMAN. It would be—I am sorry? The difference between category 1 and 2?

Mr. HUGHES. Yes.

Mr. STUTZMAN. With the higher the requirement for more capital or less capital with category 1 being backed by GSE and those who would be in category 2 not being backed by GSE. Does that make any sense?

Mr. MILLSTEIN. I am not getting it.

Mr. STUTZMAN. You are not getting that, okay. Let me go at it from a different angle then. As long as they are in conservatorship, there are differences, right, between what the GSEs are required to do compared to those in the private market; is that correct?

Mr. MILLSTEIN. Yes, they are serving different markets right now, and the private market itself is coming back slowly.

Mr. STUTZMAN. But is that—

Mr. MILLSTEIN. It is a much smaller market.

Mr. STUTZMAN. I guess that is what I am trying to get to. Are we keeping money out of the market, private money out of the market because of those differences?

Mr. MILLSTEIN. No. Look, there is a debate, I think, on the two sides of the aisle, are the GSEs crowding private capital out or is private capital not quite yet ready to take credit risk after the greatest credit crisis in 4 generations? And I think it is a little of both. This is a private capital market that is in need of repair, as you have heard from the two gentlemen to my right. There needs to be much greater standardization and transparency, an investor bill of rights in order to give investors comfort that if they buy into securitizations, their rights will be protected on the one hand, but there also needs to be a repair of their own balance sheets and willingness to take credit risk.

Mr. STUTZMAN. Okay, so loans with a debt-to-income level about 43 percent are only allowed transitional QM status if they are eligible for sale to the GSEs. Are there quality loans in this space that if they qualified for a QM without a government backstop, would that attract private capital?

Mr. HUGHES. First, go back to the last one because I think one of the misconceptions is that there is a substantial difference from the loans other than loan size that Fannie and Freddie are securitizing today versus what the private sector has, and if I look at Fannie Mae versus Redwood, aside from loan size, loan to value for Redwood is 67, for Fannie Mae it is 75. FICO score for Fannie Mae is 761. It is 770 for those, for Redwood Trust, and then primary residence is 93 percent and Fannie Mae is 89 percent. So there isn't a wide disparity for the majority of what Fannie and Freddie does from what the private sector would do.

Mr. STUTZMAN. You say there is not a wide disparity?

Mr. HUGHES. In the quality of the loans, no. Other than loan size, they are similar.

Mr. STUTZMAN. Okay.

Mr. KATOPIS. Congressman, I feel the necessity—

Mr. KLING. If I could just add for a second, what that says, and FHA is the same story, at least in terms of FICO scores, really high, and what that says is it is the originators and servicers who are scared of the market right now. It isn't a matter of which investor is scared; it is the originators and servicers who don't feel confident that they can originate or service anything other than a squeaky clean loan.

Mr. KATOPIS. Briefly, AMI members would say that we would, private capital would pursue without a government backstop, including some type of 30-year mortgage. It would have different characteristics, but private capital would pursue something without a backstop.

Mr. STUTZMAN. Do you think they would be more aggressive if GSEs and private capital were on the same level playing field?

Mr. KATOPIS. Absolutely, as we have testified, a level playing field with certain characteristics would definitely be a good signal for our investors.

Mr. STUTZMAN. Okay, thank you. I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from North Carolina, Mr. McHenry for 5 minutes.

Mr. MCHENRY. Thank you, Mr. Chairman, and thank you for your patience with this long hearing.

Thank you all as well for your patience and fortitude, if you will, to get through this. This is an important hearing to understand.

Just to reiterate, and I know you have heard this, but Ed DeMarco, whose responsibility is to oversee Fannie and Freddie, said at a hearing a month ago, "It is possible to rebuild a secondary mortgage market that is "deep, liquid, competitive, and operates without an ongoing reliance on taxpayers or at least a greatly reduced reliance on taxpayers." And he also talked about just the urgency and the need for this.

So, Mr. Hughes, in terms of private label mortgage securitization, what percentage of the market are you in? Just in the last 2 or 3 years?

Mr. HUGHES. Redwood? If we hit our goals for what we expect this year, we will be probably 5 percent of the jumbo market.

Mr. MCHENRY. Okay. So in terms of securitizations, in terms of mortgage securitizations outside of government, where are you? Is that a similar percentage?

Mr. HUGHES. Again, we would expect to do about $7 billion.

Mr. MCHENRY. Okay. So if Fannie and Freddie and the government went from, what are we, about 90 percent of the mortgage market roughly? Let's say that pulled back. How much more business could you do?

Mr. MILLSTEIN. I am not—

Mr. MCHENRY. Again, I am asking you—

Mr. HUGHES. If pulling back is done on a safe basis, and the pulling back happens with increases of guaranteed fees over time, bringing back loan limits, and again, I can't emphasize enough, we need to make the structural reforms to bring investors back because it is not a money problem. There is plenty of money out there. Historically, of the jumbo market, 50 percent of that market was securitized with the risk. The difficulty now is the uncertainty of investors who need to wade back into the water.

Mr. MCHENRY. So, going back to my question I asked you, which was could you enhance your business, could you do a lot more business with less government in the mortgage securitization marketplace?

Mr. HUGHES. Yes, if there was a level playing field.

Mr. MCHENRY. If there was a level playing field. And is there currently a level playing field?

Mr. HUGHES. Currently, there is not a level playing field, but we are getting there.

Mr. MCHENRY. Does anybody on the panel think that there is a level playing field for private capital and government capital?

Mr. Millstein, you think there is?

Mr. MILLSTEIN. Well, no. What I would say is this, that the private, the PLS market is broken, these guys are doing a great job of fixing it, creating transparency, creating structures that investors will invest in, but it is still rife with conflicts, rife with confusion about enforcement rights. These are things you guys can help fix, and if you do fix them, you will help bring private capital back. But in the last crisis, what investors in PLS found is that the rights they thought they had, they didn't have, and as a result, they are very reluctant to put aside the government's advantages on funding. As a result, they are very reluctant to step back into these.

Mr. MCHENRY. Okay. So the title of this hearing is, "Building a Sustainable Housing Finance System: Examining Regulatory Impediments to Private Investment Capital." That is the subject matter here today, and removing those impediments, I think, is a necessary and proper and good thing to the point where the Minority witness on the panel agrees with that motivation.

Mr. MILLSTEIN. Amazing.

Mr. MCHENRY. Right? It is amazing. It is fantastic. So everyone agrees we need to get more private capital into the mortgage marketplace. Will anybody say they disagree on the panel?

Mr. MILLSTEIN. The question is, how? How?

Mr. MCHENRY. Thanks. And that is the next thing I was going to say. You beat me to the punch.

Mr. MILLSTEIN. Just trying to help you.

Mr. MCHENRY. Thank you. So the question is how we get that back into the marketplace. And I think the agreement here is that it is not very easy to compete with government when it comes to this, that you need to have—we talk a lot about disclosures to those who are getting mortgages, the individual consumers, but there also needs to be that same level of clarity for those who are investing or trying to securitize or are interested in purchasing the securitization. Is that a fair assessment? You can just say yes.

Mr. MILLSTEIN. Yes.

Mr. MCHENRY. Great, fantastic.

So, with that, I will yield back, and thank you, Mr. Chairman.

Chairman HENSARLING. There are no other Members seeking recognition, so I would like to thank each of our witnesses for appearing at this hearing today. Thank you for your testimony.

Prior to adjourning, pursuant to the committee's organizing resolution, I hereby name the gentleman from Wisconsin, Mr. Duffy, the vice chairman of the Subcommittee on Financial Institutions and Consumer Credit.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing is adjourned.

[Whereupon, at 12:43 p.m., the hearing was adjourned.]

A P P E N D I X

April 24, 2013

Testimony of Martin S. Hughes

Chief Executive Officer – Redwood Trust, Inc.

Before the

United States House of Representatives

Committee on Financial Services

Hearing on

Building a Sustainable Housing Finance System: Examining Regulatory Impediments to Private Investment Capital

April 24, 2013

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Introduction
Good Morning Chairman Hensarling, Ranking Member Waters, and Members of the Committee. My name is Marty Hughes, and I am the CEO of Redwood Trust, Inc., a publicly traded company listed on the New York Stock Exchange. I appreciate the opportunity to testify on what can be done to accelerate the return of the private secondary mortgage market. I would also like to recognize diligent and thoughtful work of Congressman Garrett on this subject.

Overview
My testimony is singularly focused on the perspective of the institutional investors that are the buyers of the senior classes of mortgage backed securities ("MBS"). They are the single most critical variable to consider as you take steps to promote a robust private MBS market. Simply put, investors have the money, but without their participation there is no market.

In the wake of the financial crisis, investors in private MBS lost confidence that their rights and interests in the securities they purchased would be respected and consequently, that their investments were safe and secure. In response many senior-class MBS investors, who previously had significant asset allocations to the private MBS space, now have little or no participation at all. Today's financial world is awash with liquidity and investors are combing through different asset classes in search of safe, attractive yield. On a relative value basis, there is no logical reason why private MBS should not play a much larger role as an attractive investment class, as it was in the past.

So how do we get there? Broadly speaking, I believe we need to first address investors' demands for better risk mitigation, transparency, and alignment of interests throughout the mortgage chain. Redwood's fourteen successful securitization transactions post-crisis, totaling \$5.6 billion, proves that it can be done. Secondly, the private MBS asset class needs a chance to grow in size and reach a level that creates sufficient incentive for investors to allocate resources and capital to the asset class. Until the private MBS asset class reaches a critical mass of volume, many large investors will find it uneconomic to research, monitor, and invest in the asset class. It may be viewed as somewhat of a catch-22, but in order for the private MBS market to grow, the government needs to level the playing field and cede space to private sector financing at a safe and measured pace. In the body of my testimony that follows, I will detail specific actionable recommendations to achieve both of these goals.

Background on Redwood

Redwood commenced operations in 1994 as an investor in residential mortgage credit risk. We do not originate or directly service residential mortgages. We currently operate a prime jumbo loan conduit where we acquire individual closed loans from commercial banks and mortgage companies primarily for pooling and sale through our Sequoia private securitization platform. Redwood protects senior investors in our MBS through our investment in the subordinate securities of each securitization, which enables the senior securities to obtain triple-A ratings. In Dodd-Frank parlance, we have always held "skin in the game" as part of our business model, which demonstrates our alignment of interest with senior investors.

From 1997 through 2007, Redwood securitized over $35 billion of mortgage loans through 52 securitizations. Our average loan size was $372,000 and, interestingly, 27% of the securitized loans were prime loans with balances under Fannie Mae and Freddie Mac's (the "GSEs") conforming loan limit.

Recent Securitization Activity

Since we restarted securitization in 2010, we have securitized $5.6 billion of jumbo loans in fourteen transactions. Our issuance velocity is accelerating as five of those fourteen transactions were completed in 2013. We plan to securitize $7.0 billion this year. Additionally, the credit performance of our post-crisis transactions has been stellar. We have not incurred a credit loss, nor have we had a loan go past 90 days delinquent for credit reasons.

We have listened to investors and worked hard to meet their new requirements by putting together transactions that included even more comprehensive disclosures, better and simpler structures, new enforcement mechanisms for representations and warranties, and our skin in the game.

Currently, our primary focus has been on the prime jumbo mortgage market, or that portion of the mortgage market where the loan balances exceed the limits imposed by the GSEs for participation in their programs. We are limited to the jumbo market at this point because we cannot compete with the price and market advantages the government has conferred on the GSEs. Once the playing field is level, we stand ready to securitize prime loans of any size.

We are not that far off. On April 22, 2013, the rate Redwood was quoting for prime 30 year fixed jumbo rate (assuming a sale through private securitization) was 3.875%. This compares to Wells Fargo's prime 30 year fixed agency jumbo rate of 3.625%, and agency conforming rate of 3.50%. This is strong evidence that private capital will provide borrowers with loans on reasonable terms if investors are presented with well-structured securitizations that also have a proper alignment of interests between the sponsor and the triple-A investors.

RECOMMENDATIONS FOR GROWTH OF THE PRIVATE MBS MARKET

I would broadly describe my recommendations in three parts: first, correct MBS structural deficiencies and conflicts; second, give the private MBS market room to grow; and third, resolve pending regulations or institute a moratorium.

1. **CORRECT MBS STRUCTURAL DEFICIENCIES AND CONFLICTS**

The private market that Redwood has revived will have difficulty achieving velocity without the combined efforts of market participants, Congress, and regulators to correct structural deficiencies and conflicts. It is critical we strengthen the structural foundation that supports securitization so that investor protections are given greater emphasis. In traditional securitization structures, investors have relied on a trustee and a servicer to administer a securitization. The governing documents have not always addressed or contemplated all of the potential situations that could face the servicer or trustee or provided for an investor-friendly mechanism for initiating and resolving disputes.

- **Create a Private Market Advisory Committee, having investors as a majority of the membership, with the responsibility to establish best practices in representations and warranties and other key securitization terms. The standards would not be mandatory, but each securitization must clearly disclose any variation from the standards.**

Representations and warranties have been weak, and it has been difficult and costly to enforce the originator's or sponsor's obligations to repurchase loans where there has been a breach. We believe the representations and warranties now required by the GSEs serve as a strong benchmark. Certain contractual provisions may be vague or may not clearly delineate the rights of different tranches of a securitization or prevent manipulation of contractual cash flow triggers for the benefit of one tranche at the expense of another. Securitization trustees are not generally required to take proactive steps to protect investors. Excessive discretion may be placed in the hands of servicers without accountability to specified performance standards.

- **Establish binding arbitration as a minimum standard for dispute resolution of representation and warranty claim disputes.**

Some originators have resisted or stalled the process for legitimate claims, resulting in costly litigation. These problems have led to deep investor mistrust, and investors, unable to rely on this protection, have fled the securitization market and continue to sit on the sidelines. In order to correct this problem, we recommend requiring a formal dispute resolution process for ensuring enforcement, specifically a binding arbitration standard. Standard representations and warranties coupled with binding arbitration would provide investors with assurance that any allegation of a violation of representations and warranties will be thoroughly investigated and pursued in an efficient manner.

- **Require that securitization trusts create the position of Credit Risk Manager to manage representation and warranty claims and monitor servicer performance and actions.**

The Credit Risk Manager ("CRM") will be an independent third-party unaffiliated with any interest in the transaction, and will have two primary responsibilities. The first is to identify, investigate, and pursue claims for breaches of representations and warranties. This is important in the event the senior investors and the party that owns the first loss security disagree on whether or not to pursue a claim. The second responsibility is to conduct ongoing surveillance of the servicer's activities and report to the trustee and investors the results of the review. Although a servicer is engaged to service mortgage loans in a securitization pool for the benefit of the investors, the investors have no real way of ensuring the servicer is performing because there is currently no independent review or quality control of the servicer's decisions. The securitization documentation should provide for the CRM to have the same access to loan information and original files as the servicer to ensure that the CRM has the information necessary to perform its responsibilities.

- **Establish clear and objective uniform standards governing the responsibilities and performance of a servicer in its role as a fiduciary of the trust.**

Focusing narrowly on the role of servicers in the securitization structure, they have sometimes been placed in the position of having to interpret vague contractual language, ambiguous requirements, and conflicting directions. In their role, they are required to operate in the best interest of the securitization trust and not in the interest of any particular bond holder. In practice, without any clear guidance or requirements, they invariably anger one party or another when there are disagreements over what is and is not allowed – with the result of discouraging some triple-A investors from further investment in residential mortgage backed securities ("RMBS").

- **Prevent servicer conflicts of interest by prohibiting the owner of a second lien mortgage from being the servicer of the first lien mortgage on the same property.**

Currently, most second liens are owned by the same banks that perform servicing on first liens in which they have no financial interest. Therefore, servicers have a strong incentive to place their financial interests ahead of investors when taking actions on behalf of the trust. For example, a servicer could refuse to approve a loan modification or short sale that would benefit the first lien holder and homeowner, because doing so would directly harm their second lien financial interests.

Fortunately, there is a simple fix to this problem. Simply prohibit the owner of a second lien mortgage from being the servicer of the first lien mortgage on the same property. Servicing a delinquent loan is a nuanced, complicated process and investors must believe that their servicers are acting as honest agents throughout. No amount of disclosure or other half-measures will alleviate these concerns. The only meaningful solution is to break the economic link between first lien servicers and second liens entirely.

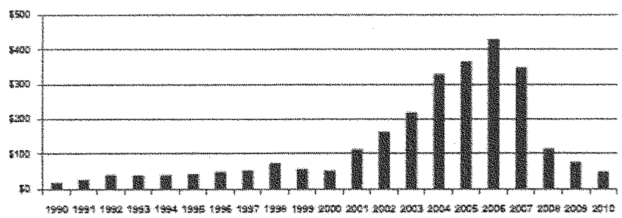
- **Establish servicer performance triggers to serve as benchmarks and an objective means for possible removal of the servicer.**

The triggers, which could be set by the Private Market Advisory Committee I suggested above, might include, among other things, average loss severity, adherence to foreclosure timelines, and average REO liquidation timelines. The triggers should be reviewed on a periodic basis. If a servicer fails a trigger, servicing can be terminated. Mechanics must be established to facilitate collective action by investors when a trigger event occurs and there is a failure on the part of the trustee to take action.

- **Control the systemic and loan level risks of second lien mortgages by giving first lien holders the ability to require their consent to a second lien if the combined loan to value ("CLTV") with all other liens will exceed 80%.**

During the housing bubble, homeowners used second liens to extract record levels of home equity, and also as a substitute for cash down payments to purchase houses. At the peak in 2006, these loans totaled $430 billion.

Annual Home Equity Originations ($Bil.)



Source: Inside Mortgage Finance

The rise of home equity lending increased the monthly payment obligations for borrowers and reduced the amount of equity remaining in their homes, leaving borrowers vulnerable to home price declines. As a result, 38% of the borrowers who used these loans found themselves underwater (or owing more than the value of their houses), compared to only 18% of those who did not. Even for well-underwritten, prime loans, the presence of a second lien increased defaults by as much as 114%.

The rise of second liens has had another, less-widely understood effect: it substantially increased losses for investors and chilled their interest in investing in newly issued MBS. To understand why, it is necessary to understand how investors evaluate mortgage loans. While a borrower's credit report, income verification, and other underwriting factors are important, the most important factor is the amount of borrower equity, or down payment. The amount of borrower's equity is the most predictive factor for a borrower's future performance: borrowers with 20% or more equity have lower default rates, while those with no equity are quicker to walk away.

Second liens undermine this analysis by making down payment information unreliable. Imagine this scenario: a borrower applies for a first mortgage with a 40% down payment – a loan with very little historical default risk. As a result, the borrower is offered a great loan at a low rate. One week later, the borrower takes out a second mortgage from a different lender for the remaining 40% of the property value. The borrower no longer has any equity and the default risk and potential loss severity on the first lien is many times higher than before. This is not a fantasy scenario: 71% of borrowers in prime, privately securitized mortgages issued between 2004 and 2007 took out second liens that were not disclosed to the holder of the first mortgage.

This level of uncertainty has a highly consequential impact on the how investors assess mortgage related investments. Since investors have no way of knowing which borrowers will cash out their equity, they must assume that everyone will. This uncertainty leads private investors to demand higher rates in return for the increased risk and means that conservative borrowers will pay higher rates to offset the risk from more aggressive borrowers.

We believe that placing some reasonable restrictions on the origination of second lien mortgages will restore investor confidence and speed the transition of the mortgage market away from taxpayer exposure. We propose that first lien holders have the ability to require their consent to a second lien if the combined loan to value ("CLTV") with all other liens will exceed 80%. If the consent is not given, then the borrower can still obtain a home equity loan, but will need to refinance the first mortgage (and pay off the first lien holder) using a standard cash out refi loan product. This proposal would allow borrowers to tap into their equity, while preserving a level of protection for investors in first liens. This new restriction is intended only to protect first-lien lenders, and investors, from excessive equity being extracted later, without their knowledge or consent.

2. **GIVE THE PRIVATE MBS MARKET ROOM TO GROW**

- **The government must begin to reduce its participation in the mortgage market, gradually and at a measured pace, by continuing to increase guarantee fees that Fannie Mae and Freddie Mac charge, and by reducing their conforming loan limits.**

The government mortgage market (GSEs, FHA, and VA) and the private mortgage market co-existed to serve the needs of borrowers for many years. Together, the two segments supported the steady growth of the market, which grew to exceed $11 trillion by the end of 2007. From 1990 through 2007, the government's market share averaged 59%, while the private sector's market share averaged 41%. In the aftermath of the financial crisis, the government's share of the mortgage market has increased to approximately 90%.

Although the housing market is recovering and private securitizations are returning, the government continues to dominate the market because the GSE's guarantee fees are below market, and the conforming loan limit remains artificially high at $625,500. As a result, for several years now mortgage lenders have been able to achieve better loan pricing by selling their mortgages into government loan programs. With relatively few loans falling outside of the very wide government parameters, the private market must struggle for market share.

The private MBS market is further constrained by a banking industry that has ample liquidity to retain prime jumbo loans on their balance sheets, leaving few loans to be securitized. For example, over the last three years, $5.0 trillion of mortgage loans have been originated, of which $477 billion were non-government jumbo prime mortgage loans, and only $5 billion of the prime jumbo loans were securitized. With little private market issuance, it is easy for institutional investors to ignore the asset class, which then inhibits rebuilding the private securities market. Simply put, you can't expect a market to develop unless there is product available.

We note that post-crisis, the private asset-backed securities markets for auto loans, credit card loans, and commercial real estate loans are up and functioning, while the private RMBS market is barely developed beyond Redwood's program. One of the reasons is the pervasive below-market government financing in the residential mortgage sector that is crowding out traditional private market players.

We were encouraged by the Federal Housing Finance Agency's ("FHFA") actions last year to increase guarantee fees, and we hope those increases will continue until a level playing field has been established. Similarly, if the GSE's conforming loan limit is decreased, the private market would aggressively compete for the newly jumbo loans without any market disruption, similar to when the temporary increase (from $625,500 to $729,750) in the conforming loan limit was allowed to expire in September 2011.

3. **RESOLVE PENDING REGULATIONS OR INSTITUTE A MORATORIUM**

- **Remove the crippling uncertainty caused by unfinished regulations by requiring that the unfinished rules that are past deadline must be issued within 4 months, or be subject to a 4 year moratorium. This would provide certainty in the form of final rules or the status quo for a long enough period of time to allow a private MBS market to develop.**

The incomplete status of regulations required by the Dodd-Frank Act has constrained the development and growth of the private MBS market. Markets require certainty about the rules of operation so that regulatory compliance can be assured. Firms will be cautious about entering the private MBS market out of concern that final regulations might soon turn a good business decision into a bad one. Markets typically manage to adapt to new regulations and continue operating under the new rules. The private MBS market is no different, but I must point out one very critical exception that would cause great harm to the development of the private MBS market.

The Credit Risk Retention proposed rule requires the creation of a Premium Capture Cash Reserve Account that would paralyze the private market if adopted. In addition to the basic 5% risk retention requirement of the rule, it would require the issuer of the MBS to fund a premium capture cash reserve account with the positive difference between projected cash flows on the loans and payments due on the securities. This new requirement is an unnecessary additional layer of credit enhancement that will make private MBS transactions uneconomic. These accounts were not required in the language of the Dodd-Frank Act, yet were included in the proposed rule. I hope the regulatory agencies writing the Credit Risk Retention rule will recognize the importance of this issue and remove the account from any final rule.

So my message here is simple, please get the rules right and get them out right away. The markets will generally adapt if the rules of the road are known. If the rules cannot be completed in a timely fashion, then let's recognize that and place a moratorium on their issuance.

FHFA Single Securitization Platform and Risk Sharing

Finally, your invitation letter asked for my views on the FHFA's recently announced plans to have the GSEs develop a single securitization platform and new risk sharing arrangements. Redwood supports the effort to modernize the infrastructure of the GSEs. We see benefits to standardizing operations across the two GSEs and the evolution of the risk sharing transactions using either a senior/sub or a synthetic structure. We do want to point to two areas of focus for us in the private label securitization market.

First, while the single platform will provide several benefits for the GSEs, expanding it to the private label market and requiring the implementation therein may unnecessarily constrain that market. Our view is that the implementation of a consistent single platform will serve as a good metric and consistent benchmark to enable private label security ("PLS") investors to quickly and efficiently compare the particular attributes of a private label securitization to that benchmark. While there is general consensus that standardization would be beneficial, the benefit comes from providing a benchmark, not through establishing a constraining mandatory framework.

Second, once the GSEs engage the credit markets in a risk sharing arrangement, the investor base for the non-government guaranteed securities will shift from a rate and pre-payment sensitive investor base to a credit sensitive investor base. The investment analysis performed by credit investors is based more heavily on the credit attributes of the mortgage loans and borrowers as well as the structural mechanisms for representations and warranties and for enforcement mechanisms. Therefore, credit investors will need more robust disclosures and pre-securitization due diligence.

Conclusion

I commend you for focusing this hearing on investors. I firmly believe that the private secondary mortgage market can grow quickly to provide liquidity to a very large share of the mortgage market, without the need for any government guarantee, if the needs of investors are met and the government gives the private market room to grow.

AMI ASSOCIATION OF MORTGAGE INVESTORS

WRITTEN STATEMENT

ON BEHALF OF

THE ASSOCIATION OF MORTGAGE INVESTORS (AMI)

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES
FINANCIAL SERVICES COMMITTEE ON

Building a Sustainable Housing Finance System:

Examining Regulatory Impediments to Private Investment Capital

APRIL 24, 2013

by CHRIS J. KATOPIS,
EXECUTIVE DIRECTOR

Introduction

Mr. Chairman, Ranking Member Waters, and distinguished members of the Committee, thank you for the opportunity for the Association of Mortgage Investors (AMI) to testify today. Our statement will focus on the issues and concepts regarding the current impediments for private capital in the housing finance system, the concerns of investors, and some proposed legislative solutions. A key goal of the system is the flow of mortgage credit and capital from investors to the borrower – and then back again. At its essence, the present situation limits the availability of housing credit and the reach of the American Dream of home ownership. In response, AMI would like to discuss how some common-sense legislation can impact the critically important topic of returning private capital to the U.S. mortgage market.

The Association of Mortgage Investors (AMI) commends you and your House colleagues for your leadership in pursuing responsible and effective oversight and vigilance to enhance the health and effectiveness of the U.S. financial markets, and in particular, the U.S. housing finance system. The renewed investment of private capital returning into the U.S. housing finance system and increasing future investor demand in the mortgage market will require addressing a number of current market problems which are presently obstacles for private label securitization. As AMI has previously testified, the current mortgage investors suffers from market opacity, an asymmetry of information between investors and originators or, it can be said, a thorough lack of transparency. Moreover there are:

- Poor underwriting standards;
- A lack of standardization and uniformity concerning the transaction documents;
- Numerous conflicts-of-interest among servicers and their affiliates;
- Antiquated, defective, and improper mortgage servicing practices;
- An absence of effective legal remedies to investors for violations of RMBS contractual obligations and other rights arising under state and federal law; and,

- Unwarranted federal and state government intervention in the mortgage market (*e.g.*, the use of eminent domain as a foreclosure mitigation tool).

Accordingly, we commend the Chairman and your colleagues for acknowledging these issues facing investors and our public institution partners, as well as, your efforts toward developing solutions. Given the following testimony regarding problems obstructing the reemergence of private capital in the U.S. housing finance market, we would like to work with you and your colleagues in developing legislation and solutions.

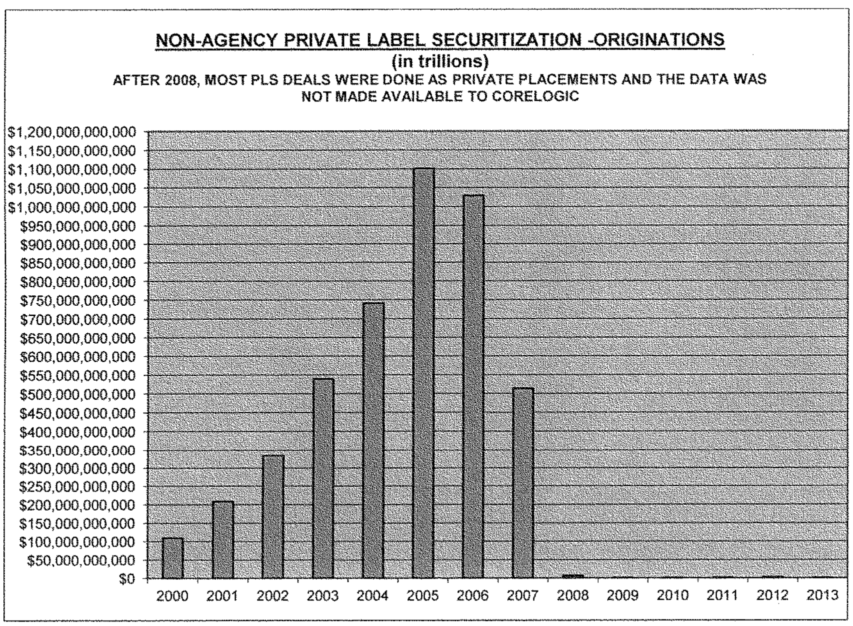
I. Background

The AMI was formed to become the primary trade association representing investors in mortgage-backed securities (MBS), along with life insurance companies, and state pension and retirement systems, university endowments. It has become the sole unconflicted buy-side investor group and developed a set of policy priorities that we believe contribute to achieving the goal of restoring private market securitization. AMI was founded to play a primary role in the analysis, development, and implementation of mortgage and housing policy that keep homeowners in their homes and provide a sound framework that promotes continued home purchasing. In practice, only three sources of residential mortgage capital exist in the United States: (1) balance sheets of financial institutions such as banks; (2) the government (currently including Fannie Mae, Freddie Mac and FHA); and, finally (3) private securitization, which is effectively shut down for the reasons described herein.

At its height, today's U.S. mortgage market consisted of approximately $11 trillion in outstanding mortgages. Of that $11 trillion, approximately one-half -- $5.4 trillion -- are held on the books of the GSEs as agency mortgage-backed securities (issued by one of the agencies) or in whole loan form. Another $4.0 trillion are on the bank balance sheets as whole loans or securities in their portfolios, of which $1 trillion are second liens (*i.e.*, home equity loans/lines of credit or closed end second mortgages). Of the $1.1 trillion outstanding second mortgages, only about 3-4% of the total (or approximately $40 billion) is held by private investors in securitized form. The remaining $ 985 billion in first lien mortgages reside in private label mortgage-backed securities (MBS). AMI's members hold a significant portion of these mortgages through our investments.

The following analyst chart illustrates this point, namely that the PLS market, and private capital, has virtually left the U.S. mortgage market. This trend is uncontested. The future is likely to reflect a similar situation unless the Congress establishes the necessary systems, structures, and standards for private capital to return.

Chart 1



Source: Data provided by RBS and CoreLogic.

Investors are prepared to invest private capital into the mortgage market and, hence increase housing availability and affordability. However, we seek the government's development and deployment of these enhanced securitization standards and safeguards to restart the virtuous circle of private capital into the market and to borrowers. These will promote the certainty, transparency, uniformity, enforcement, recourse, and other criteria that will contribute to improving the functioning of capital markets for all investment asset classes, especially those pertaining to a necessity of life, namely housing. Your work will contribute to helping to keep Americans in their homes, making credit available, and the development of effective tools against in this challenging housing and foreclosure environment.

Mortgage investors share your frustration with the slow restoration of the housing market and the need to assist homeowners that are truly hurting. In fact, the markets for Residential Mortgage Backed Securities (RMBS) securitization have virtually ground to a halt since the financial crisis for reasons that we will enumerate.[1] We are hopeful that meaningful solutions can be implemented more quickly, and we believe that our interests are aligned with responsible homeowners. As difficult as it may be to believe, many of the most sophisticated investors were as victimized and abused by the servicers and their affiliates as were many consumers. Investors are essential in order to rebuild the private mortgage market. However, investors and their private capital will only return to a market which is transparent, has non-conflicted stakeholders, and the protection of contract law.

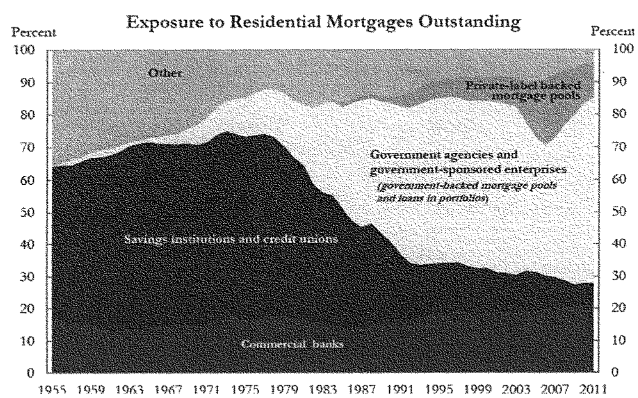
[1] The exceptions to this include a small number of PLS securitizations which are very limited in size and scale. *See, e.g.*, http://www.bloomberg.com/news/2012-09-10/redwood-to-sell-securities-backed-by-313-2-million-of-mortgages.html.

II. The Role of Mortgage Investors in the Marketplace

Mortgage investors, through securitization, have for decades contributed to the affordability of housing, made credit less expensive, and made other benefits available to consumers. Today, however, as one can see on the below chart, mortgage investors are continuing to exit the market. As illustrated by the chart below, the government's dominant market share -- as shown in yellow -- can only be transitioned back to the private sector as shown by blue and green -- by fixing the asymmetry of information, poor underwriting, conflicts-of -interest by key parties in the securitization process, as well as, the inability to enforce rights arising under contracts, securities and other laws. This list is by no means intended to be exhaustive. Accordingly, the U.S. economy at-large is hurt by the decreasing availability of mortgage credit.

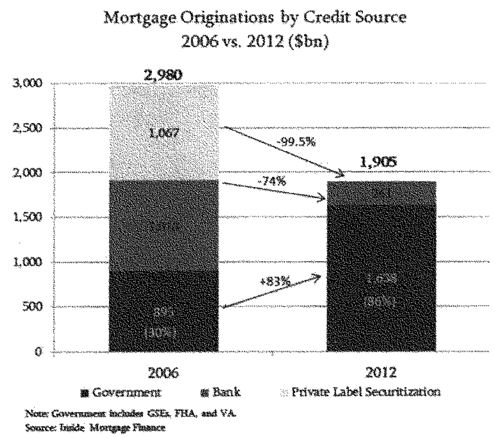
Chart 2

The Mortgage Market Needs Diverse Capital Sources



Source: Federal Reserve Board.
Note: Other includes life insurance companies, finance companies, real estate investment companies, private pension funds, state and local government retirement funds, households and nonprofit institutions, and non-financial corporate and non-corporate businesses.

Chart 3



MORTGAGE CREDIT IS STILL FALLING

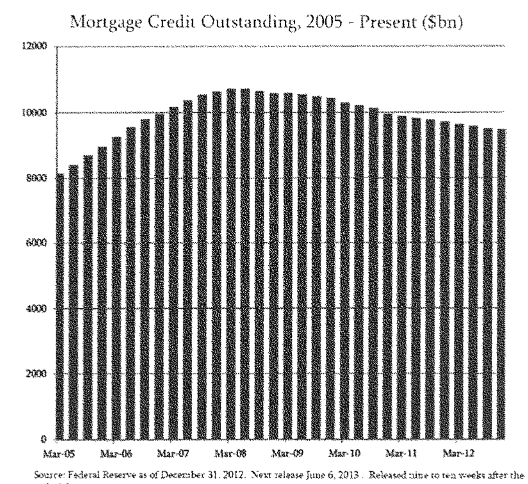


Chart 4, above, represents the decreasing amount of mortgage credit since the financial crisis.

A. Mortgage Investors' Interests Align with Responsible Borrowers

Mortgage investors are aligned with both homeowners and the government in our shared goals of keeping responsible Americans, including low and middle-income families, in their homes and rebuilding and maintaining a vibrant real estate market. The benefits of securitization are widely known.[2]

In fact, the maintenance of a healthy securitization market is a vital source of access to private capital for mortgages as well as autos and credit cards. Moreover, an efficient securitization market provides more capital and at a cheaper cost to mortgage loan originators, which allows them to make more loans to additional qualified borrowers. The use of private mortgage-backed securities as a funding source has many benefits, including:

- expanding the availability of housing finance opportunities for low- and middle-income families;
- reducing the cost of credit;
- equitably distributing risk in the mortgage finance industry; and,
- preventing a build-up of specific geographic risk.

In sum, these features and many others are those of a market which makes access to capital cheaper and thus spurs more mortgage lending.

Mortgage investors seek effective, long-term sustainable solutions for responsible homeowners seeking to stay in their homes. We are pleased to report that mortgage investors, primarily the first lien holders, do not object to modifications as part of a solution. We strive for additional remedies to assist homeowners. Likewise, if a borrower is speculating in the housing market, engaging in a strategic default or paying only their second-lien mortgages, then they should not be eligible for receiving subsidized first lien interest rates. Potential structural changes that should be examined include: full recourse, blockage

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[2] *See e.g., Securitization and Federal Regulation of Mortgages for Safety and Soundness,* CRS REPORT FOR CONGRESS at 2 (RS-22722, Oct. 21, 2008). ("This *securitization* of mortgages increased the supply of funds available for mortgage lending).

of interest payments on second lien debt if the first lien is in default, prohibitions on second lien debt above a specified loan-to-value (LTV). With a restored, vital and healthy securities market, we will be able to attract more private capital into mortgage investments and, in turn, provide more affordable mortgages for potential qualified home buyers.

III. Obstacles to the Return of Private Mortgage Capital

The current legal and regulatory landscape presents numerous obstacles for private capital returning to the mortgage market and RMBS in particular. In essence, mortgage investors simply seek the salient facts underlying a mortgage transaction in order to price the risk to their capital. AMI has offered a number of policy solutions which are described in its *Reforming the Asset-Backed Securities Market White Paper* (March 2010).[3] Just as with traditionally chartered bank-servicers, the vast majority of capital market investors have many options as to where to deploy their capital -- they do not have to fund mortgages, and they will only do so if it makes sense on a risk-vs-return basis. In the case of mortgages, they look at known returns vs. perceived risks.

A. Inability to Compete with the Government

Presently, the government subsidizes mortgage rates by keeping the cost of credit low by charging insufficient amounts through its "g-fee" at the time it creates a GSE securitization product. Although these fees are rising, they are still insufficiently low for the private label securitization product to compete in the market. It is natural that money is attracted to a product where the government guarantees risk at subsidized rates versus a private market with no guarantee or one with private insurance. Raising g-fees to market levels will help attract private capital through crowding in. This is necessary-- but not sufficient -- to get private capital into the market in greater size than it is right now.

With respect to risks, because investors (a) got badly burned on mortgage-backed securities during the financial crisis and (b) had their legal and economic rights trampled on in the aftermath to the

[3] http://the-ami.org/2010/03/22/ami-white-paper-reforming-asset-backed-securities-market/

crisis, in legal battles with various parties and some "help homeowners" initiatives, there is much that the Congress can do from here to lower perceived risks to investing in mortgages. Congress can encourage private-sector competition and create clear "rules of the road" so the mortgage market is restored. This is absolutely essential.

B. Competition, Crowding Out and Making the GSEs Truly Private

In terms of competition, private investors in mortgage-backed securities right now are "crowded out" by the government to a large degree. Between quantitative easing and government pressure for lower lending rates to spur economic growth, private capital simply cannot compete at these credit spreads.

Even if FHFA as conservator of the GSEs were to raise g-fees to market levels by regulatory order, this would not solve the problem. Fannie Mae and Freddie Mac are in the same business as private mortgage investors and mortgage insurers, bearing credit risk in exchange for financial compensation, and they should not have the low-funding-cost and other advantages of government sponsorship. Congress should prepare a transition plan to end government sponsorship and the credit-risk-bearing functions of these entities must be fully privatized, to ensure a level competitive playing field.

It is an indisputable fact of the financial markets today that banks, mortgage insurers and private capital market investors simply cannot – they do not have enough capital to – support the $10 trillion U.S. mortgage market without the credit-risk-bearing functions of Fannie Mae and Freddie Mac. This is point is graphically illustrated by the multi-color chart of mortgage capital sources, above at page six. Accordingly it must be noted:

- Commercial banks do not provide more than 20% of the nation's outstanding mortgage capital, and adding thrifts and credit unions does not get them above 30%.
- Mortgage insurers fit into the "other" category on the chart, and at only a few billion in mortgage capital are insignificant in terms of U.S. mortgage funding needs.
- Private-label mortgage-backed securities at the height of the recent boom were never more than 20% of the market themselves and it will take a lot of work (see below) to get back to this level going forward any time soon.

While simply wiping out Fannie Mae and Freddie Mac would be good for investors from a competitive standpoint, the effects this would have on mortgage availability would be disastrous, seriously wounding the now-recovering housing market and causing losses to mortgage lenders, insurers and investors on outstanding loans.

Besides, wiping out Fannie Mae and Freddie Mac would put even more mortgage market power into the hands of the nation's largest banks, which is not and should not be a government goal.

The easiest and most direct way to have less government capital and more private capital in the mortgage market is for the government to sell its stakes in genuinely transformed GSEs into the capital markets and get taxpayers paid back. While Fannie Mae and Freddie Mac's debt-fueled purchase of low-quality MBS and insufficient equity capital were what got them into trouble before conservatorship, Congress can put their portfolios into run-off, pay off the debt, and ban them from buying MBS going forward, without wiping out their core guarantee businesses on high-quality mortgages which were never a problem. Subprime and other low-quality loans could be left to financial institutions and investors that are not systemically important.

After restructuring the companies to prevent problems of the recent past: (a) limiting them by charter to high-quality guarantees without allowing debt-fueled MBS portfolios; (b) ensuring sound regulation with appropriate equity capital; (c) severing government sponsorship and entity-level backstops; and, (d) imposing appropriate political limitations, the core mortgage guarantee businesses can be sold into the private markets with no government backstop, and the funds realized can repay the government for its assistance as with AIG. In bearing mortgage credit risk, the new privatized companies should compete on an equal footing with banks, mortgage insurers and private-label MBS -- with market-based costs of capital, g-fee rates and no special privileges.

C. Trust Indenture Act: Investor Bill of Rights and Bank Quality Control

Another useful source of inspiration for solving the issues at hand may be found in the Trust Indenture Act. As history teaches us, the 1929 financial crisis resulted in a crash of the stock (equities) markets. Yet, it is less well-known that the 1929 crisis also resulted in a bond industry crash as well. In response, in 1934, Congress tasked the Securities and Exchange Commission (SEC) to explore solutions for re-vitalizing the corporate bond market. The SEC prepared a report authored by the Commissioners, including future U.S. Supreme Court justices William Douglas and Abe Fortas.[4]

i. The 1936 SEC Commission Report's Finding

The 1936 SEC report on the problems surrounding the corporate bond market bears striking similarities to the issues facing the RMBS investment space at present. The report reads as if torn from recent financial news headlines:

> *The basic problem is to refashion the trust indenture [a corporate bond] for the purpose of according greater protection to investors. That entails prescribing a minimum standard specifications for the conduct of trustee and issue thereunder. . . . This means a more proper balance between the interests of investors and requirements of issuers ... where its failure to take swift and positive action leave the investors without effective protection of their interests . . . In this situation the inherent incompatibility of interest arises, common to all creditors and debtors" "*

Accordingly, the SEC report catalogs a number of the resulting problems from the lack of appropriate investment standards, systems, and safeguards present up until Congress' enactment of the Trust Indenture Act (TIA). In particular, the TIA addressed the following defects of the bond industry of the early 20[th] century, and as well, any forthcoming new bill should also address these issues in the RMBS space:

- The eligibility and duties of a Trustee;
- The Trustees' duties in connection with breaches of representations and warranties;
- Transparency and periodic reporting;
- Creditor rights; and,
- Registration before the federal regulators pursuant to the Securities laws.

These parallel the issues that mortgage investors have noted before Congress and in our other advocacy.

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[4] The full report may be found on the AMI website at: http://the-ami.org/2012/04/27/the-sec-tia-reeport-to-the-senate-banking-committee/

ii. The 1936 SEC Commission Report's Results

The result of the 1936 SEC report was Congress' enactment of the Trust Indenture Act (TIA). This landmark legislation has enabled the corporate bond market with the standards and structures necessary for its efficient operation – so much so that investors do not even realizes that it is in effect.

Today, in 2013, we believe that the Congressional enactment of a new, explicit parallel to the TIA for the residential mortgage-backed securities industry would have dramatic, positive effects for the return of private capital to the U.S. mortgage market. Further, such TIA legislation would benefit many demographics of borrowers, including first-time home borrowers, low- and middle-income borrowers. The drafting of such a TIA-RMBS bill can be accomplished in several ways. AMI has developed a draft version of the TIA-RMBS bill which we are happy to share with the Committee. Further, we appreciated and supported Chairman Garrett's 2010 legislation, the "Private Market Enforcement Act," H.R. 3644, as well as similar legislation offered by Congressman Brad Miller.

We believe that the recommendations below, which are detailed in depth in the AMI white paper, support healthy and efficient securitization and mortgage finance markets, with more information made more widely available to participants, regulators, and observers; incentivize positive economic behavior among market participants; reduce information asymmetries that distort markets and are entirely consistent with the government's traditional roles of standard-setting in capital markets.
This process resulted in a report to Congress on how underwriters sold bad corporate bonds into the market, the legal documents were weak, trustees didn't protect bondholders, investors had few rights and no real remedies to enforce the rights they did have.

- In response, Congress passed the Trust Indenture Act of 1939, which mandates that bonds sold into the financial markets have to have legal structures and documents that work for investors. This statute has worked for almost 75 years without an overhaul, and now we don't worry about the bond market blowing up because of bad legal structures the way the mortgage markets did.
- The problems we see in the MBS market today are almost exactly the same as we saw in the bond market after the 1929 crash. This argues for the same solution, mandatory

> standards and legal structures – a solution from Congress which the corporate bond market has successfully lived with for the past seventy years. Of the thousands of financial professionals trading corporate bonds in the US market today, few know what the Trust Indenture Act is, but all see that it works.

In response to critics who oppose *"let the private market figure this out if it's so important, why does the government need to step in?"* -- private investors are here to tell Congress that there is no negotiation of the fundamental non-economic terms of mortgage-backed securities. Hence certain important national goals are not achieved. Underwriters do not negotiate with smart investors or even average investors, they write legal documents and make selective disclosures to sell deals to the marginal investor, the one who doesn't read the papers and doesn't know or understand what he or she is buying. These are the MBS that are sold into the capital markets, and that more sophisticated investors have to research and trade.

This dynamic leads to the classic "race to the bottom" -- minimal disclosures as to the mortgages securitized, no effective enforcement of representations and warranties that investors rely on, and weak legal structures that don't protect investors in practice. This is what led to the illiquidity in the markets and investor losses in the financial crisis, and private capital will not come back in size to fund mortgages if investors think this could happen again.

We need to mandate systems, standards and structures, to get data on the underlying mortgages out into the market so credit risk can be priced and compensated for appropriately. We need to have third parties – investor representatives -- enforcing representations and warranties, instead of servicers protecting their affiliates that would be liable, so underwriters give accurate data to investors and stand behind their financial products. If investors understand and can control the credit risks they are taking, they will be fairly compensated for the occasional losses they agreed to bear.

A Trust Indenture Act (TIA) for Mortgage-Backed Securities would include, among other things:

- real-time public loan-level information available to all investors, not just ratings agencies, both at the time of underwriting and as loan performance emerges;
- "cooling off" periods when MBS are offered so investors have a real opportunity to analyze what they are being offered;
- public deal documents for all MBS for investors, other market participants and regulators;

- standard pooling and servicing agreements for all MBS, with enforceable, understandable, and non-waivable, standard representations and warranties going all the way back to loan originators, which R&W would be effectively enforced by third parties with the minimum cost and litigation;
- clear and standard definitions, including for fundamental mortgage concepts like "delinquency" and "default";
- addressing conflicts of interest involving servicers (including second liens and third-party services like force-placed insurance) to make sure they manage the mortgage pools in the best interests of investors;
- protection for investors against servicers settling their legal liabilities to third parties with trust property (*i.e.* robosigning settlements that allow servicers to making modifications on investor-owned loans as consideration) and against local governments seizing their mortgage loans under eminent domain;
- simplified MBS pool structures and governance structures, for greater secondary market liquidity and effective investor supervision of trustees and servicers; and,
- better credit ratings for MBS investors, based on the same detailed data that the investors should get and updated continuously over time.

The quality-control functions essential to the proper functioning of MBS trusts must be mandated by the government and paid for by the economics of mortgage securitization transactions – as we have seen over the last several years, these functions will simply not be performed otherwise. Transactions that depend on dumping bad loans on investors for their economics to work should not be brought to market, period.

Congress should put a single regulator with appropriate experience in charge of all mortgage-backed securities, who can work with the CFPB to ensure mortgage servicing standards address the needs of investors as well as homeowners. We should make sure that servicer compensation is properly structured to accommodate different housing market conditions. We need uniform accounting and reporting policies for MBS pools and uniform procedures for loan servicing and restructuring known to all parties up front and not changed ad hoc in response to political demands.

To deal with the conflicts of interest between first-lien loans and second-lien loans, there needs to be a new inter-creditor regime for securitized mortgages. Owners of first-lien loans should have consent rights over second lien loans that lead to unsustainable loan-to-value (LTV) levels, should get paid before the owners of second-lien loans are paid by the same borrowers, and should control any modification or restructuring process. Property-level losses should be allocated properly among creditors based on legal priority and junior creditors should be impaired before more senior creditors.

If investors get a fair deal going forward, Congress can end the "putback wars" that have paralyzed loan origination. This will allow banks to limit their legal exposure the next time the market turns down, cutting off the "tail risk" that they will have to buy back defaulted loans -- so long as they meet new required market standards for data completeness, timeliness and integrity and appropriate protection of investors.

D. *Mortgage Market Infrastructure*

Beyond securitization, we need to reform and modernize the mortgage market infrastructure. To this end, Congress should consider:

- Facilitating a single national Internet database of mortgages – perhaps for real estate ownership as well that tracks, validates and clarifies mortgage loan ownership, putting to rest troublesome issues that have dogged the legal system since the foreclosure crisis began;
- Mortgage servicing standards that address needs of investors as well as those of borrowers;
- A single national uniform foreclosure law, non-judicial but still ensuring important homeowner protections, to govern enforcement of security interests in real property exactly the way Article 9 of the Uniform Commercial Code handles security interests in personal property; and,
- It is hard for investors to charge the lower interest rates normally associated with secured lending, when the difficulties of foreclosing in property in many jurisdictions makes the capital we have invested effectively unsecured.

Recent experience has shown us all that our mortgage market is national in scope. Congress should not be afraid to use pre-emption and model uniform state laws to bring about consistency among states in dealing with these important mortgage-related issues that affect investors not only nationwide, but around the world.

E. *Political Risk of Eminent Domain*

Another serious impediment to private capital arises from the government's intervention in the housing market which results in uncertainty and the possibility of severe loss. Investors characterize this as the new "political risk premium" surrounding our activity. Recently, we witnessed such harmful activity in the mortgage space with both the National Mortgage Settlement[5] and the proposed use of eminent domain as a foreclosure mitigation tool.

We fully concur with the mainstream concerns of many, including the Federal Housing Finance Agency (FHFA) and think tanks across the spectrum,[6] regarding the use of eminent domain, including its dubious constitutionality, the potential to limit consumer credit and harm communities economically, the impact on securities and other institutional holdings, and the ultimate losses imposed upon tax-payers due to alterations to the Government Sponsored Enterprise's (Freddie Mac and Fannie Mae) securities holdings. We further wish to emphasize that among the consequences of this use of eminent domain is the likely further curtailment of access to the thirty-year fixed mortgage, an integral part of the American Dream, and additional harm to tax-payers that are holders of the Enterprise and Private Label Securities (PLS) through their public or private pensions, 401Ks and/or mutual funds.

The use of eminent domain to restructure residential loans is a controversial, untried, and likely an unconstitutional use of government power.[7] The use of such government power is an extremely blunt instrument; the burden on its proprietary and the justification for its use must reside with its advocates. While some would claim that it is a last resort, there are no indications that this is true or that, in the case of performing mortgages, said borrowers should be entitled to relief. Either way, it appears that the negative consequences will always outweigh the purported benefits. Even though AMI is extremely sympathetic to the problems surrounding the housing sector and borrowers for the past six years, the case has not been satisfactorily made for the use of eminent domain, particularly given all of the programs available to troubled borrowers, some of which are too new to have fully registered their potential.

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[5] http://www.nationalmortgagesettlement.com/

[6] Think tanks and NGOs across the political spectrum question the use of eminent domain in this context. See, e.g., the Progressive Policy Institute (PPI)'s report: http://www.progressivepolicy.org/wp-content/uploads/2012/07/07.2012-Gold_Can-Eminent-Domain-Help-Underwater-Homeowners.pdf

[7] Cornell Law Professor Robert C. Hockett, a key architect, spokesman for the eminent domain proposal and past MRP consultant has conceded that this plan is untried and legally unverified. "In an interview Wednesday, Hockett conceded that the eminent domain seizure of a mortgage loan has apparently not been tested explicitly in court." http://newsandinsight.thomsonreuters.com/Legal/News/2012/07_-_July/Eminent_domain,_MBS_and_the_U_S__Constitution__a_one-sided_fight_/

Further, housing analyst and government data suggest that after a six-year housing crisis, many indicia, including home prices and relief for borrowers, are showing consistent improvement.

In sum, the risk of the use of eminent domain in this manner poses more risks to the housing markets, communities, and the availability of credit, than any advantages portrayed by those who seek its financial gain. We are pleased that when the concept is reviewed in its entirety and the facts come to bear, communities are rejecting eminent domain in this context. For these reasons, AMI supported those efforts to protect investments from government takings, as with the last session's introduced bill, "The Defending American Taxpayers from Abusive Government Takings Act," H.R. 6397.

IV. Conclusion

Today, more than half a decade after the financial crisis, mortgage funding through the capital markets remains in a weakened state on government life support. The landmark Dodd-Frank Act did not address at all the many serious issues discussed in this testimony, and mortgage investors now ask that Congress step in to help restore and strengthen the private market, through establishing standards, systems, and rights. There are tremendous gains the government can make in improving competition and decreasing risk, and therefore increasing the participation of private capital.

Mortgage investors believe that the vibrancy and effectiveness of the U.S. capital markets can be restored, in part, by enhancing the transparency around fundamental regulatory structures, standards, and systems. Toward this goal, the government has a role – not through the heavy-hand of big government, but rather, the light touch of a prudent standard-setter and facilitator. With appropriate standards and rights for the holders of asset-backed securities, securitization would achieve the goals sought by many – the more efficient funding of capital markets, lessening volatility, and the resulting better economic activity. In the absence of transparency, the future of the U.S. housing finance system will remain dark, hurting America's global competiveness and our domestic health. The results will include less home lending, more expensive credit, and fewer housing options and less opportunity for working class Americans. These are the reasons that we need solutions providing for more transparent systems and restarting our capital markets. Hopefully we can all look forward to a mortgage funding market that is larger, more private, and more systemically sound than the one we have now.

Thank you for the opportunity to share the views of the Association of Mortgage Investors with the Committee. Please do not hesitate to use the AMI as a resource in your continued oversight and crafting legislative solutions concerning the many issues under review. We welcome any questions that you might have about securitization, representations and warranties, or other mortgage industry topics.

Statement of Arnold Kling*

Prepared for the U.S. House Committee on Financial Services

Hearing on

Building a Sustainable Housing Finance System: Examining Regulatory Impediments to Private Investment Capital

April 24, 2013

*Arnold Kling is a member of the Financial Markets Working Group of the Mercatus Center. Views expressed here are his own.

Chairman Hensarling and ranking member Waters, thank you for the opportunity to appear today before the committee on financial services to discuss the issue of returning private capital to the housing finance system.

Let me start by admitting that my involvement with housing finance took place in the late 1980s and early 1990s. I hope that my experience with history can compensate for my lack of familiarity with current practices.

I joined Freddie Mac as a senior economist just as the Savings and Loan Crisis was reaching its final stages. Many of the solutions to the savings-and-loan crisis came back as problems in the recent debacle. Securitization was supposed to get the mortgage risk out of government guaranteed depository institutions, but instead massive bailouts were needed. Changes to accounting rules and capital regulations were intended to correct regulatory shortcomings in the 1980s, but they also proved counterproductive in the latest episode.

Today, with all of the focus on credit risk, I worry that policy makers today are paying too little attention to interest-rate risk. Just when the public is being led to expect that better regulation is the solution to financial stability, we may instead be setting the stage for the next meltdown and the next round of bailouts.

My main concern about bringing private capital back into the mortgage market is that I do **not** believe that the private sector has the ability to bear the risk of holding large quantities of 30-year fixed-rate mortgages. The money managers and Wall Street experts who say otherwise are the same people who assured us in 2005 and 2006 that mortgage securities backed by subprime loans posed no risk to the financial system. Instead, my warning to this committee would be that if there is a sharp rise in interest rates some time in the next decade, you can bet that taxpayers will once again be called on to bail out large financial institutions with decimated portfolios. I will elaborate on this later.

Taxpayers would be better served if more of the mortgages originated in the United States were similar to the five-year rollover instruments common in Canada today. Such a loan would have a thirty-year amortization schedule, but its interest rate adjusts to market rates every five years. Short-term adjustable-rate mortgages, such as those where rates adjust every year, are too much of a gamble for borrowers. However, the thirty-year fixed-rate mortgage is too much of a gamble for lenders. When lenders gamble, the winnings always end up in private hands and the losses usually wind up with the taxpayers. The five-year instrument is a better compromise, reducing the scope for gambling by lenders without exposing borrowers to undue risk.

I do not wish to dictate the 5-year mortgage. However, I believe that if government maintains a neutral stance between 5-year instruments and 30-year fixed-rate instruments, and it neither directly nor indirectly subsidizes investors in 30-year mortgages, then the market may very well offer 5-year loans on terms that attract borrowers.

With that said, here are some suggestions for what policy makers can do to help bring private capital back into the mortgage market.

1. **Stop** demonizing mortgage originators. It is impossible to make mortgage decisions perfectly. Sometimes, you make a reasonable decision to approve a loan, and later the borrower defaults. Sometimes, you make a reasonable decision to deny a loan, and yet the loan would have been repaid. Beyond that, good luck with home prices can make any approval seem reasonable and bad luck with

home prices can make any approval seem unreasonable. During the bubble, Congress and regulators beat up on mortgage originators to get them to be less strict. Since then, Congress and regulators have been beating up on mortgage originators to be especially strict. I expect mortgage originators to make mistakes, but the fact is that they do a better job without the "advice" that they get from you. Right now, lending institutions are cautious, because they fear being blamed for any decision that turns out badly. Mortgage credit will remain scarce until regulators clarify rules and guidelines that will allow them to make decisions without being subject to arbitrary punishment afterward.

2. **Stop** demonizing mortgage servicers. Mortgage servicing is a competitive business with low profit margins. Servicers have a lot more experience than you do in dealing with troubled loans. By insisting that they "cure" such loans in large numbers, you have greatly raised the cost of their business. Given these cost increases, the only loans anybody wants to service nowadays are loans with large down payments and very high credit scores. Just as with mortgage origination, the absence of rules and guidelines, combined with a "gotcha" mindset among regulators, is driving companies out of the mortgage servicing business and making it more difficult to obtain a loan.

3. **Start** bringing down loan the maximum loan sizes at Freddie Mac, Fannie Mae, and FHA. As the range of the public market narrows, the private market will expand.

4. **Start** developing a national automated title system using what is called the Torrens title approach. With a Torrens title, current ownership of a property is definitive, and prior claims on title are resolved with compensation that does not affect the current owner. This eliminates the need for title searches and title insurance. The current fragmented courthouse title system imposes unnecessary costs on mortgage originators, servicers, and securitizers.

5. **Start** developing a national standard for loan servicing agreements, and include recourse in the standard agreement. With recourse, a borrower with the means to repay a loan cannot just "mail in the keys." Recourse loans will discourage speculative home purchases while lowering the interest rate for genuine home buyers.

6. **Continue** to develop a national standard for a conforming mortgage loan for mortgage securities. The key factors to standardize are the minimum down payment, positive amortization, and limiting the loan purpose to owner-occupied purchase or no-cash-out refinance. On the other hand, government should not impose inflexible income ratios, debt ratios, or documentation standards.

7. **Continue** to support consumer protection, financial literacy, and programs to help families save for down payments.

Finally, I urge you to set modest objectives for housing policy. When the decision is made in Washington about whether people should own or rent, what type of mortgage they should obtain, and where the capital on that mortgage should come from, the result is to empower the lobbyists and the special interests. I am talking about the real estate agents, mortgage bankers, home builders, Wall Street firms, and community action groups that wrap themselves in the flag of what they call the American dream of home ownership. These organizations have too much power and too little shame. When policy is wide-ranging and ambitious, the special interests win and the taxpayers lose.

Interest-rate Risk and Capital Markets

The most popular mortgage product with consumers in the United States today is a 30-year fixed-rate mortgage with no prepayment penalty. Unfortunately, there is no class of investors for which a 30-year fixed-rate instrument that is instantly callable is a natural fit.

The private sector has never demonstrated an ability to manage a portfolio of thirty-year fixed-rate mortgages. The savings and loan industry went bankrupt in the late 1970s, because their cost of funds rose above the interest rates they were earning on the mortgages that they had originated over the previous decade.

By the 1990s, the dominant providers of thirty-year fixed-rate mortgages were Freddie Mac and Fannie Mae. However, they were not able to satisfy demand by issuing mortgage-backed securities and selling them to other institutions. Instead, their growth took place in their "retained portfolios," meaning whole loans and mortgage-backed securities financed by issuing debt. In other words, Freddie and Fannie took on the task of managing the interest-rate risk on thirty-year fixed-rate loans.

To finance their loan portfolios, Freddie and Fannie issued both ordinary bonds and callable debt. An example of callable debt might be a bond with a fixed interest rate and a stated term of 10 years but giving the agency the option to call the debt after 5 years, meaning that the debt would be paid off at par.

These debt instruments only re-distributed some of the interest-rate risk from Freddie and Fannie to private investors. Another portion of the interest-rate risk was hedged using derivatives. Even with those hedges, Freddie and Fannie retained some exposure to extreme movements in rates.

Some remarks about interest-rate risk management in the period of Freddie and Fannie growth:

1. Investors showed very little appetite for 30-year mortgages. Instead, their appetite was for straight and callable debt.

2. The use of derivatives shifted risk into what we now call the "shadow banking system." Regulators had no way of knowing where this risk was being held. Some regulators have suggested that putting derivatives on an exchange would solve this problem. However, no exchange has ever traded the sorts of derivatives that are needed for hedging 30-year mortgages. These are deep, out-of-the-money options. The writers of such options will not be able to afford to put up significant collateral up front. As the values of the options change, the exchanges will have to make margin calls on the option writers. In an environment where interest rates move dramatically, these margin calls may lead to bankruptcies among the option-writers, the exchanges, or both. There is no way to test the system ahead of time to see whether it will work.

3. In fact, the system for distributing interest-rate risk that emerged as Freddie and Fannie grew was never tested. Over the last two decades, we have not had a spike in interest rates like the one that we experienced in the 1970s. We do not know what would have happened to the derivative markets or the markets for callable debt in a stressful environment. We do not know whether Freddie Mac and Fannie Mae held adequate capital. We do not know whether the institutions that supplied out-of-the-money options in the derivatives market would have been able to meet their obligations.

What we do know is that the balance sheets of Freddie and Fannie were highly brittle, and the loss of confidence by investors in the middle of 2008 made it impossible for the two companies to continue as independent entities. Morever, no one has suggested returning to a situation in which government-sponsored enterprises support the 30-year mortgage market by issuing their own debt. The institutional replacement for the Freddie and Fannie loan portfolios has yet to be specified.

Right now, there is considerable interest-rate risk embedded in an institution that never used to have any: the Federal Reserve. Federal Reserve officials are aware of a contingency in which a rise in interest rates causes the bank's earnings to go negative. That in turn might require asking for an appropriation of funds to cover operations. The fact that the Fed is taking on interst-rate risk indicates to me how little appetite there currently exists in the private sector for such risk.

With any proposed reform of the mortgage finance system that contemplates a dominant role for thirty-year fixed-rate mortgages, the question that should be asked is: where will the interest-rate risk reside? Suppose that we experience a spike in interest rates some time in the next decade. Which institutions will incur losses, and how will they absorb those losses?

When I ask these questions of money managers, they say "Don't worry. We are the professionals. Managing risk is our business." But such vague reassurances are unacceptable coming from an industry that just recently required massive bailouts. If we do not know precisely where the risk will go, then we cannot rule out the possibility that it will end up in government-insured banks or Systemically Important Financial Institutions (the regulators' euphemism for "too big to fail"). Indeed, *any* institution that takes on a significant share of the interest-rate risk will *become* systemically important, just as AIG Insurance became systemically important because of the significant role it played in the allocation of mortgage credit risk.

In summary, I do not believe that the thirty-year fixed-rate mortgage can be issued in large volume without taxpayers becoming liable for interest-rate risk. Conversely, if we reform the housing system so that the private sector truly bears the risk, then borrowers would encounter a large differential between the cost of a thirty-year fixed-rate mortgage and the cost of a loan with an interest rate that is fixed for only five years. Borrowers should be making their choices based on this true cost differential.

Statement by

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before the

Committee on Financial Services

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Chairman Hensarling, Ranking Member Waters, Members of the Committee, thank you for the opportunity to testify on impediments to private investment in the U.S. housing finance system.

In 2008, the U.S. government effectively nationalized the residential mortgage market. It placed the largest providers of funding to this market, the Federal National Mortgage Association (Fannie) and the Federal Home Loan Mortgage Corporation (Freddie) (together, the enterprises), into federal conservatorships and established an equity backstop for their solvency from the U.S. Department of the Treasury (Treasury), thereby creating an explicit government guarantee of over $5 trillion of their mortgage-backed securities (MBS) and corporate indebtedness. The Federal Housing Administration (FHA) and Department for Veterans Affairs tripled their combined footprint in the market. The largest mortgage originators and servicers in the country—the nation's largest banks—received trillions of dollars of loans from the Federal Reserve, hundreds of billions of TARP equity from Treasury, and new deposit and transaction account guarantees from the Federal Deposit Insurance Corporation (FDIC), all to ensure that they remained in business and did not engage in fire sales of, among other things, their mortgage assets. The Federal Reserve and Treasury became the largest buyers of agency debt and MBS in the world to ensure stable pricing of mortgage credit in the secondary markets.

Without the government's intervention, mortgage credit would have disappeared for almost all Americans because all of the major providers of such credit—Fannie and Freddie and the country's major banks—would have failed.

There is growing consensus across the political spectrum that continued government dominance of the mortgage market is unacceptable. In 2012, ninety percent of the $1.9 trillion of new mortgage originations were supported by the government. Through credit from a variety of "government sponsored" entities, taxpayers today bear the risk of loss on $6.5 trillion of the $10 trillion of residential home mortgages outstanding in America. The FHFA and Treasury have prevented Fannie and Freddie from building any real reserves to cover potential future losses on their guarantees of $4.5 trillion of mortgage backed securities, leaving taxpayers on the hook for mortgage losses if we experience another downturn in home prices. Access to mortgage credit for most Americans remains limited despite historic low rates, because underwriting standards have been restrictive post-crisis. Private risk-taking in the mortgage markets remains muted.

My testimony will focus on the actions that I believe this Congress and the Administration should take to restructure the government's role in the mortgage market and to accelerate the process of bringing private investors back into the fold.

During my recent tenure as the Chief Restructuring Officer at Treasury, I had primary responsibility for the oversight of the government's capital commitments to AIG, which rivaled in size the amount of capital invested to date in Fannie and Freddie. After a series of restructurings of that $182 billion commitment, we designed and implemented a recapitalization plan for AIG that involved (i) selling off almost half of its insurance businesses to generate sufficient proceeds to repay its debt to the Federal Reserve and (ii) the exchange of the Treasury Department's $50 billion of preferred stock into 92 percent of the common equity of the company. The Treasury Department then sold the common stock into the public markets in a series of secondary offerings in 2011 and 2012, fully eliminating AIG's perceived government sponsorship. In the end, taxpayers made almost $23 billion on an investment that the OMB originally projected the government would lose $50 billion.

Although housing finance reform is more complex in several respects than the AIG restructuring, I believe that a similar corporate finance solution combined with broader housing finance reform should allow Congress to:

1. End the conservatorships within three years;
2. Fully recover the taxpayers' substantial investment in Fannie and Freddie; and
3. Create conditions under which private investment capital can return to a market now almost completely dominated by the government.

State of the U.S. Mortgage Market

We have to deal with the world as we find it, not as we wish it to be. Housing is central to the health of the nation's economy and to the wealth that remains within the grasp of ordinary Americans. Therefore, it is particularly important that, in designing policy to reduce the government's now dominant role in mortgage credit formation, we do not engage in wishful thinking about the appetite of private investors for mortgage credit risk. These investors are still reeling from losses generated by the greatest house price decline in four generations.

Where are private investors and private providers of mortgage funding today, six years past the peak of the housing bubble? Nibbling at the edges.

Let's start with the banking industry. Since the crisis, the sector as a whole has reduced its exposure to the residential mortgage market by approximately $580 billion, nearly 20 percent off its peak. It is true that after four years of significantly cutting their holdings of single-family residential loans and incurring hundreds of billions of dollars of losses related to those assets, in 2012 commercial banks expanded their holdings. However, that increase was a mere 2.8 percent or approximately $59 billion in mortgage loans. Meanwhile, savings and loan institutions have continued to shrink their exposure to the mortgage market—by $103 billion in 2012. As a result, overall holdings of residential mortgages in the banking sector fell 1.7 percent last year, continuing the basic trend since the peak of the housing bubble in early 2007.

Next, let's look at the private mortgage insurers (PMIs). While it is true that some have recently been able to raise new capital in the public markets and that the aggregate amount of primary insurance in force in the sector is no longer in free fall, total capital in the sector was down from a peak of $17 billion in 2006 to roughly $5 billion at the end of 2012, which is at least $100 billion short of the capital necessary to support the $4.5 trillion in MBS guarantees of the enterprises.

Finally, there is the private-label securities (PLS) or non-government-guaranteed MBS market. Issuance of PLS reached $6 billion in 2012, and forecasts suggest that there could be $20 billion of new issuance this year, down from $740 billion in the peak year of 2006. A handful of issuers account for this greatly diminished volume, and the characteristics of the mortgages underlying the securities issued are similar. A recent issuance, Sequoia Mortgage Trust 2013-4, is representative. All loans in the pool were long-term fixed-rate mortgages, and the weighted average coupon was 3.8 percent. But the average loan size was $805,000, the weighted average combined loan-to-value ratio was 65 percent, and the weighted average original FICO (credit score) was 773. In other words, the mortgages in these pools represent the cream of the crop—not the majority of America.

Moreover, as we think about what it might take to get private investors to take mortgage credit risk in this market and to pick up more of the risk being borne by taxpayers through Fannie and Freddie, it is important to understand that newly issued PLS are structured to provide immense protection for investors. The recent Sequoia issuance included four senior tranches, three interest-only strips, and three subordinated tranches. What does that mean? If mortgages in the pool default, investors in the three subordinated tranches take losses up to the amount of their investment before investors in the senior tranches suffer any loss at all. Given that the average combined loan-to-value ratio for the underlying mortgages is 65 percent, home prices would need to decline by 35 percent before the investors in the subordinated tranches would suffer any loss at all. And then, because the subordinated tranches constitute 6.25% of the total debt secured by the mortgages in the pool, investors in the senior tranches would still be protected against loss so long as the underlying homes could be sold upon default for 61% of the value of the home at the time the mortgages were originated.

Policymakers need to avoid wishful thinking as they consider whether the sale of these new private label securities truly signal the return of private risk-taking in the mortgage market that is capable of displacing the government. First, while growing, the total volumes might represent one to two percent of aggregate demand. Second, the securities being sold are backed by mortgages that represent the cream of the crop. Finally, and most telling, the issuers of these new private label securities have had to retain the subordinated tranches in their new issues to get investors to buy the senior tranches at all. Regardless of potential risk-retention rules, private investors are not only demanding that issuers have "skin in the game" but also that the issuer's skin be in the "first loss" tranche in the new structures, and that there be a mountain of homeowner equity ahead of them as well.

Further, we must remember that during the period leading up to the crisis, the PLS market was rife with fraud, misrepresentation, fast and loose underwriting practices as well as conflicts of interests. Investors in these securities suffered badly from these practices that ultimately resulted in default rates in excess of 25% and hundreds of billions of dollars of credit losses. No one should be surprised that investors remain reluctant to take mortgage credit risk in such a tarnished market.

The slow re-opening of PLS markets gives me hope for the future, but it also leads me to be extremely skeptical that private investors will have the appetite to displace much of the credit risk that Fannie and Freddie currently underwrite in the US mortgage market any time soon. Last year there were roughly $1.9 trillion in single-family mortgage originations in the United States, of which Fannie and Freddie provided support for approximately $1.3 trillion. Going forward, estimates for normalized annual total originations are in the range from $1 trillion to $1.5 trillion. A PLS market projected to do $20 billion of issuance in 2013 clearly cannot handle anything approaching these annual volumes.

Again, as we map a way forward in housing finance reform, we must be very careful in the assumptions we make about the appetite of private investors for taking mortgage credit risk.

Impediments to Private Capital

GSE Conservatorships

The conservatorships of the enterprises are the greatest impediments to the return of private investors to the mortgage market. Private investors need to understand what the future of the enterprises looks like before committing capital to this market in size. Further, FHFA has managed Fannie and Freddie during the conservatorships in a manner that makes it difficult for others to compete. Fannie and Freddie have been operating with essentially unlimited leverage and no capital to absorb future losses. With an open line of equity from Treasury to cover any such losses, they continue to underprice the risk of loss on the mortgages they have guaranteed during the conservatorships vis-à-vis potential private competitors.

No private insurance company can compete against a government-controlled insurance business operating with no capital and no real return on capital hurdles. Moreover, if a private insurance company were as critically undercapitalized as Fannie and Freddie are today, regulators would insist that profits be retained to build capital so as to create a cushion against future potential loss—not distributed to equity holders. Yet, under last summer's amendments to Treasury's preferred stock purchase agreements, all profits are being swept out of the companies into the general fund, leaving taxpayers exposed to potential future losses on the trillions of dollars of new guarantees written since Fannie and Freddie were placed into conservatorship.

Worse, the enterprises are being used to fund government initiatives unrelated to housing. The Temporary Payroll Tax Cut Continuation Act of 2011 required the enterprises to increase the fees they charge to guarantee mortgages by 10 basis points and to pay those fees directly to the Treasury.[1] The projected $35 billion in proceeds from that increase were spent in January and February of 2012 but will not be collected in full until 2021. The CBO assumptions on which that "pay for" is based is that the enterprises' current market share will remain essentially unchanged between now and 2021. Reform is complicated enough without having to solve for this shadow tax regime. Its creation implies to private investors that the conservatorships will remain in place for at least the coming decade.

The same Act also directed the FHFA to increase guarantee fees to levels that "appropriately reflect the risk of loss, as well as the cost of capital allocated to similar assets held by other fully private regulated financial institutions." As the Chairman of this Committee has noted, that has not happened yet. At the end of 2012 the average guarantee fee charged by the enterprises on newly-originated mortgages was just over 50 basis points. That is roughly double what they charged two years ago. Yet they are still not losing market share to new entrants.

Why? So long as the status quo persists, and the enterprises remain under government control, the pricing and credit characteristics of loans that Fannie and Freddie are permitted to support are

[1] The Act also imposed the same requirement on the FHA.

subject to non-economic influences that could have a negative impact on the future returns of private investors. Private capital cannot enter a market in size when the dominant players in that market are subject to such substantial political risk.

The reason that private investors ran for the hills in 2008 is that they could not estimate their downside risk in a collapsing housing market and were unwilling to invest in mortgages at any price. Underwriting models have improved, in part because of the data we have from this most recent crisis. However, the fact that lending standards remain so tight is a signal that market participants remain unwilling to be exposed to tail risk at any price. The recent PLS issuances illustrate this point: with 35 cents of homeowner equity and 6.25 cents of issuer "skin in the game" ahead of them on every dollar of new PLS investment, investors in the senior tranches would not be exposed to loss even if home prices declined again as sharply as they did between 2006 and 2009. Investors are unprepared to take the risk of another housing downturn.

FHA Pricing

There is emerging evidence that private mortgage insurers are now competing with the FHA at the current prices it charges for its guarantee. The FHA Reform Act of 2010 removed the 0.55 percent premium cap, and allowed the Administration to raise premiums to 1.55 percent. The current FHA premium is 1.35 percent, and private mortgage insurers have expanded market share and raised nearly $3 billion of new capital in the past year. Certainty around FHA requirements—for example, whether it will compete for prime borrowers in the future—could further increase the opportunity for and role of PMI in the market. But, they will need to raise significant incremental capital to do so.

New Regulations

Regulations also impact the availability of private capital in the mortgage market. Banks face a new capital regime that makes it more expensive to hold mortgage assets, in particular non-conforming mortgages. The final "Qualified Mortgage" (QM) rule reinforces this bias. While lenders have a safe harbor for conforming mortgages for up to seven years, lenders are exposed to potential liability from violations for other mortgages. Although it has not been finalized, it is likely that the "Qualified Residential Mortgage" (QRM) rule will have a similar impact.

I caution strongly, however, against concluding that these regulations should not be implemented. On the contrary, the United States just experienced the worst financial crisis and recession in four generations. It was in no small part because of weak capital requirements and loose regulation of providers of mortgage credit. While they may not be perfect, Basel III and the Dodd-Frank Act represent significant positive steps toward a better capitalized and less "fast and loose" financial system.

That said, I do believe that regulators need to finalize the QRM rule as soon as possible and provide certainty to the market over how QM and QRM will be implemented. That is easier said than done, in part because regulators have no clearer picture of the future role of Fannie, Freddie, FHA and other government providers of mortgage credit than private investors do.

Impediments to PLS Issuance

The list of impediments to a liquid PLS market is long. I group them into four categories: disclosure, inter-creditor rights, enforcement, and servicing.

Investors in PLS were burned during the crisis in part because information about the mortgages underlying their securities was either difficult to obtain or hard to understand. Rating agencies suffered from the same problem in their diligence and analysis. Today both investors and rating agencies are reluctant to touch many kinds of PLS issuances. Moreover, many investors no longer assume that rating agencies can substitute for their own diligence.

The crisis also revealed that the current regime that defines rights between first and second lienholders is defective. Loans secured by second liens eliminated the buffer of equity that many first lienholders expected would protect them in a downturn. When home prices fell precipitously, aggregate loan balances exceeded the value of many homes and, despite their legal priority, first lienholders found themselves treated the same as or worse than second lienholders. Further, second liens have inhibited modifications and principal reductions in troubled loans, and have exposed inherent conflicts between servicers—who frequently own second liens—and investors in PLS backed by first liens.

There are a number of problems with current mortgage enforcement processes. Conflicts of interest and weak incentives in servicing can impose unnecessary costs on borrowers and reduce returns to PLS investors when a borrower defaults. Trustees are poorly compensated to enforce PLS investor rights. Investor remedies are poorly defined and vary issue to issue. Technical defects in the foreclosure process hurt borrowers and PLS investors alike. Separately, improper transfer of title for mortgages underlying PLS prevents trustees from having standing to foreclose on behalf of investors, and it allows creditors of originators and securitizers to seize the asset to satisfy their claims in bankruptcy—potentially denying the PLS investor's recovery altogether.

The mortgage servicing industry suffers from widespread conflicts of interest, a one-size-fits-all compensation regime, and the lack of uniform standards for restructuring or modifying mortgages. Many second lienholders also service first liens, and servicers frequently have economic relationships with third-parties who play a role in foreclosure processes. Servicers historically have been overpaid to service performing loans and underpaid to service non-performing loans. Although that model might have survived minor waves of defaults, it proved woefully inadequate to survive a shock of the magnitude that we just experienced.

Fortunately there seems to be consensus on many of the solutions to these problems. Some require legislative action, some regulation, others actions by industry alone. But nearly all will take a long time to be implemented, and it will take even longer for market participants to get comfortable with them.

A Way Forward

Resolving Fannie and Freddie is the most important step that Congress can take to remove investor uncertainty and encourage private investment in the US mortgage market. However, that is impossible to do without affecting the future market structure and the role of the government in it. And it is irresponsible to do so without a realistic appraisal of the ability of private investors to replace the government's role.

I propose a transition plan that we can begin implementing immediately to bring private capital into the market. The plan has four key features.

1. We must wind down the government-sponsored hedge funds that Fannie and Freddie ran, terminate the government charters that created an "implied" guarantee of their debt, and recapitalize and sell their mortgage guarantee businesses to private investors.

2. The government should provide reinsurance for qualified MBS in exchange for a fee, properly calibrated to protect taxpayers against the risk of potential loss. This is similar to the FDIC's deposit insurance and represents a dramatic shift in structure and substance from the pre-crisis model of a free implicit guarantee of undercapitalized "government-sponsored" entities.

3. Structural impediments to PLS issuance should be removed.

4. Housing affordability initiatives should be funded from a fee on all MBS issued with government reinsurance.

This plan offers several benefits.

- ***Restarts private markets***. The plan provides a smooth path to a new system in which the private sector plays the leading role, there is sufficient private capital ahead of the government reinsurance to absorb losses in most situations, and taxpayers are compensated for providing a public backstop.

- ***Ends the private-gain, public-loss GSE model***. GSE charters are terminated and taxpayer-subsidized portfolios are wound down.

- ***Repays taxpayers***. Modeled on the successful resolution of the government's investments in AIG, the privatization allows Treasury to recoup its $122 billion of net investments in Fannie and Freddie.

- ***Protects our economy***. Privatized, adequately-capitalized mortgage guarantee businesses and government reinsurance provide a bridge to a stable mortgage system without risking a sudden reduction in mortgage credit that would depress house prices and risk another recession. And importantly, they afford policymakers the tools to reduce the Government's credit exposure over time as private risk appetite increases.

- ***Ensures affordability***. Mortgage credit will be available during times of stress, long-term fixed-rate mortgage products will be available for most Americans, lending standards can normalize, and funding for affordability initiatives is transparent.

Ending the GSEs and Capitalizing the Private Mortgage Market

The first step is to end the GSEs and to recapitalize and privatize their mortgage guarantee businesses. The highly-levered investment portfolios each firm ran before the crisis--in effect, government-sponsored hedge funds--should continue to be wound down under federal supervision. The public charters that allowed private shareholders to benefit on the backs of taxpayers should be terminated. The private mortgage guarantee businesses should be recapitalized and sold as private "first loss" insurers, with significant capital standing in front of the government's new reinsurance. They will have no special privileges, and no implicit or explicit guarantee of their liabilities. As private companies, they will have no ability to issue government guaranteed debt to fund expansive on-balance-sheet mortgage portfolio investments as they did under the "government sponsorship" model.

Without special privileges, the firms will be forced to compete with other private companies willing to pay the government for its reinsurance, with strict regulation to ensure that community banks can originate and securitize mortgages on an even playing field with the giant banks that have come to dominate the business over the past four years under the auspices of the conservatorships. The new government reinsurer should also be directed to facilitate structured products that provide a variety of ways for private investors to shoulder more mortgage credit risk, thereby reducing the government's footprint. To the extent that the newly privatized mortgage guarantee businesses exceed acceptable market share parameters, the new government reinsurer should impose higher capital requirements on them, just as the largest banks are to be subject to capital surcharges. And there should be no regulatory capital arbitrage permitted among providers of mortgage credit: the same capital charges should be applicable whether a mortgage is held on a bank's balance sheet or guaranteed through "first loss" insurance.

Efforts to establish a single securitization platform that could serve as a market utility should continue, as it represents an important step towards facilitating a competitive marketplace. Such competition will spur innovation and reduce systemic risk in mortgage securitization. As the system spurs new entrants in mortgage finance, and diversified institutional sources of mortgage funding develop, we will no longer be held hostage to the fate of any one or two large institutions' survival as the government was in the summer of 2008. Any one of them could fail—including the privatized mortgage guarantee businesses—without the threat of a housing market collapse. Shareholders will be wiped out and any mortgage guarantee infrastructure transferred to new ownership.

To build the capital required to support their becoming the "first loss" insurers of their outstanding $4.5 trillion of MBS (and thereby to protect taxpayers on the new government reinsurance), FHFA should immediately direct the enterprises to increase their fees to market levels and keep them there until a sufficient capital cushion is built. In a market structure where the government provides reinsurance to cover tail risk, higher guarantee fees will also have the collateral benefit of creating a pricing umbrella under which new private investors and insurers can compete. Treasury should suspend its profit sweep so that the mortgage guarantee businesses can retain those guarantee fees and build up capital. Building capital is the first step in getting them ready to be sold back into private hands. It is also essential to building a stable private mortgage market that can absorb most shocks without triggering government reinsurance.

Privatizing newly recapitalized and state-chartered mortgage-guarantee businesses would also enable Treasury to recover its substantial investment in the companies and begin moving toward a safer housing finance system driven by market incentives, with private capital first in line for losses. Taxpayers deserve both outcomes. Once the companies have enough capital to cover their "first loss" insurance exposure, Treasury should convert its preferred stock into a sufficient percentage of common stock to ensure that taxpayers' investments can be repaid in full. The firms could then be released from government control and Treasury's equity in the restructured entities sold to private investors over time. This is exactly what Treasury did with its 92 percent stake in AIG, with great success.

I believe that this plan will not only return all of Treasury's net investments in the enterprises, but that its adoption would also have an immediate positive impact on budget negotiations. I estimate that the plan could score between $100 and $190 billion in deficit reduction (that is, a negative subsidy) under Congressional Budget Office accounting.

Transforming the Government Guarantee

Since 2008, Treasury has backstopped the enterprises' solvency while preventing them from building any capital to support the trillions of dollars of MBS they have guaranteed during the conservatorships. I urge you to transform this convoluted guarantee of the enterprises' solvency into a secondary backstop of qualified MBS, and to charge the market an appropriate price for it.

This is a political hurdle for conservatives, who are understandably reluctant to establish yet another government credit-support program. But the guarantee of the mortgage market through Fannie and Freddie today cannot be replaced until it is acknowledged for what it is. Each day the current system remains in place the likelihood increases that the profit sweep becomes embedded in the federal budget, and that Treasury's backstop for the enterprises and the conservatorships become permanent, leaving private capital on the sidelines indefinitely.

Moreover, it is unrealistic to expect that the government will not again intervene in a future housing crisis, or that private markets alone will provide a stable source of financing for the sector in good times and bad. Previous attempts in U.S. history to rely on purely private mortgage markets resulted in spectacular crashes. We experienced it in the 1880s when originators issued debt backed by their mortgage pools, in the 1900s when New York title guarantee companies sold participation certificates backed by mortgages they had originated, and in the 1920s when single-property real estate bonds were used to finance construction projects. Poor underwriting, misaligned incentives, lax regulation, and investors' inability to judge credit quality undermined every model. And in each of these instances, investors fled the market for years after the crash and mortgage credit evaporated with disastrous effects on the economy as a whole. The flight of investors from PLS markets in the recent crisis illustrates that this propensity for wide swings in private investor appetite for risk remains equally strong today.

Therefore, I believe it is better to structure and price an explicit guarantee behind a well-regulated and properly capitalized private market *ex ante* than to bail out an undercapitalized, pro-cyclical system *ex post*, and to suffer distortions from implicit backstops and hidden subsidies along the way.

To that end, I propose establishing a Federal Mortgage Insurance Corporation (FMIC) modeled on the FDIC. The FMIC would have a limited mandate: ensuring stable credit for the housing system and protecting taxpayers against loss. To do so, it would (i) establish standards for qualifying single-family and multifamily mortgage products and practices, (ii) sell reinsurance for MBS comprised of mortgages that meet those standards, and (iii) supervise entities that purchase that reinsurance for safety, soundness, and capital adequacy. Well-capitalized private MBS insurers and issuers would be first in line to cover losses on a qualified MBS pools reinsured by the FMIC. The FMIC would guaranty incremental shortfalls in payment on the MBS (after the exhaustion of the "first loss" providers primary coverage) and enforce capital requirements for first-loss providers to ensure that they can meet their insurance obligations. Proceeds from FMIC's reinsurance fee would be placed in a reserve fund that builds over time and used only to fund operations and offset potential losses. The FMIC must also be insulated against political interference on the model of the FDIC, with a budget off limits for any purpose beyond its limited mandate.

Will the FMIC misprice its reinsurance? Yes, just as private mortgage insurers mispriced their insurance before the crisis and no doubt will again. But the FMIC can fund any shortfalls from the qualified MBS market through fees over time—not from taxpayers through a government bailout. This is exactly what the FDIC did in 2009 when it experienced a shortfall in its Deposit Insurance Fund and imposed special and pre-paid assessments on banks. Although Congress granted the FDIC authority to borrow as much as $500 billion from Treasury, the FDIC did not take $1. Further, Congress can establish a hard floor for the guarantee fee based on actuarial models that take the recent crisis into account. It can also require stress testing of the FMIC's fund and reinsurance pricing on a periodic basis.

Removing Impediments to PLS Issuance

To address deficiencies in disclosure, loan-level information should be published for all mortgages in securitized pools. This would allow investors, rating agencies, and regulators to evaluate collateral and expected economic performance at the time of underwriting and over the life of the mortgage-backed security. Freddie has already taken a significant step in this direction, publishing online loan-level information at time of issuance and on a monthly basis for all securities issued after December 1, 2005. A national electronic registry of mortgage liens and servicing relationships should be established and published. This could be done by modifying or replacing the existing Mortgage Electronic Registration System (MERS). Deal documents for MBS should be available electronically to investors, rating agencies and regulators, as should servicing performance and fees.

The FMIC should be directed to establish a new inter-creditor regime for mortgages. First lien investors should have rights to approve second liens that would lead to an unsustainable combined loan-to-value ratios. Loan-level losses should be properly allocated in the pools according to lien priority. Second lienholders should not be paid before the first lienholder without consent. And first lienholders should control the restructuring or foreclosure process.

To address deficiencies in the enforcement of investor rights under pooling and servicing agreements, the Trust Indenture Act of 1939 should be amended to apply to MBS or it should be replicated for MBS. The FMIC should be directed to work with industry to establish standard pooling agreements with model representations and warranties. The new MERS should address transfer of title defects. And a model non-judicial foreclosure law should be drafted and implemented.

The FMIC should follow in the footsteps of the FHFA to address deficiencies in servicing, in particular by establishing and enforcing rules to eliminate conflicts of interest and to ensure adequate investment by servicers in the systems and people necessary to handle the work outs of troubled mortgages. Second lienholders should be barred from servicing first liens they originate, a rule which will also serve to stimulate servicing competition. Economic relationships between servicers and third parties involved in the foreclosure process should be severed. The FMIC should be directed to work with industry to establish uniform accounting policies and procedures for loan servicing and restructuring.

Ensuring Affordability

The steps above should ensure that mortgage credit will remain available during times of stress. FMIC insurance will also ensure a deep, liquid market for qualified MBS, the benefits of which will flow to borrowers and lenders during normal times. The plan also ensures that long-term fixed-rate mortgage products will be available for most Americans. Absent some form of government reinsurance, it is likely that most mortgages will be shorter term and/or variable rate products, forcing the least sophisticated in the system—homeowners—to manage interest rate risk. Further, by providing clarity about where the housing finance system is headed and by putting private capital first in line for losses on the government-reinsured product, lending standards can begin to normalize.

However, there are tradeoffs. The affordability goals embedded in the charters of Fannie and Freddie would disappear along with their "government-sponsored" status. Although Community Reinvestment Act provisions would continue to apply to mortgage market participants, neither the privatized mortgage guarantee business nor the FMIC would have affordability goals. In their place, I propose that each new MBS sold with government reinsurance pay a fee over the life of the security to fund federal and state affordability initiatives. For example, proceeds from a fee on government-reinsured MBS could be directed to the Housing Trust Fund and Capital Magnet Fund established by the Housing and Economic Recovery Act of 2008. Those proceeds could also be allocated among state public housing agencies in order to fund affordability programs, such as the expansion of the oversubscribed Housing Choice Voucher Program.

Some suggest that this proposal risks creating a two-tier system: one for those with access to the new qualified MBS and PLS markets, and one for those without. This is one reason why it is essential that community banks have the ability to access the benefits of secondary markets in the new market structure. They are more likely than the larger banks to funnel local deposits and other funding into mortgages in their local communities. It is also why the FHA must have the ability to expand during times of crisis for non-prime borrowers and, at all times, to charge rates for its guarantee that are appropriate for its mission while protecting taxpayers.

Conclusion

Some advocate for the wind down of the guarantee businesses of Fannie and Freddie, either by stepping down loan limits or restricting their underwriting authority in some formulaic way. The theory is that private investors will fill the void in the market created by the enterprises' forced withdrawal and that the transition will be seamless.

My question to the advocates of this approach is: what if it isn't seamless and substantial demand for mortgage credit goes unmet? If policymakers get the size or pace of a forced wind down wrong, we will suffer a credit contraction, house prices will fall and the U.S. economy will once again be at risk for a recession. When I ask the proponents of wind down "what then?", the answer is that the FHFA will wind the enterprises back up. This is precisely the kind of start/stop government policymaking that prevents private investors from taking risk. Until Congress provides private investors with a credible transition plan from the government-dominated market that exists today to one with a better balance of private risk and public support, I predict that private risk taking in the mortgage markets will remain muted.

My proposal is consistent with suggestions to use structured credit vehicles to stimulate private risk taking. The difference is that my proposal does not rely on those vehicles as the exclusive way to encourage private capital into the market and to reduce the government's footprint. Creating well-capitalized "first loss" insurers from the guarantee businesses of the enterprises is consistent with trying to induce private investors to buy a "first loss" piece of Fannie and Freddie MBS. The difference is this: I believe we can accomplish the former over the next three years if we have the political will to do so, whereas it is near impossible to predict the timetable over which private investors will purchase a sufficient amount of "first loss" securities in future Fannie and Freddie MBS to protect taxpayers on their backstop of Fannie and Freddie's solvency. And, there will be no capital ahead of the government on the enterprises' current $4.5 trillion of outstanding MBS.

These paths are also not mutually exclusive. Taken together they present a safe, responsible way to return private capital to mortgage markets, to end the conservatorships, to get the taxpayers' investments in the enterprises repaid in full, and to restore balance to the housing finance system on a more certain timeline.

Thank you, again, for inviting me here today. I appreciate the opportunity to assist the committee in working through the myriad challenges inherent in comprehensive housing finance reform.

Appendix I

Housing Finance Reform – Restructuring the Government's Role

Housing Finance Reform Proposal

- **The proposal provides a transition to a stable housing finance system driven primarily by private capital**

  1. Fannie Mae and Freddie Mac are eliminated, and their mortgage guarantee businesses are recapitalized and privatized with no government support, repaying taxpayers in full for the amounts invested in them during the conservatorships
  2. The government sells reinsurance on qualified mortgage-backed securities (MBS) with private insurance companies and investors first in line for losses
  3. New protections for investors in private-label MBS are enacted and disclosures are enhanced to restore confidence in a tarnished market
  4. A fee is imposed on government-reinsured MBS to fund federal and state affordable housing initiatives

✓ **Restarts private markets**

- Provides a smooth path to a new system in which the private sector plays the leading role, there is sufficient private capital to absorb losses, and taxpayers are compensated for providing an FDIC-like backstop

✓ **Ends the private-gain, public-loss GSE model**

- GSE charters are terminated and taxpayer-subsidized portfolios are wound down

✓ **Repays taxpayers**

- Modeled on the successful AIG restructuring, recapitalization and privatization, the plan allows Treasury to recoup $122 billion of net taxpayer investments in Fannie and Freddie

✓ **Protects our economy**

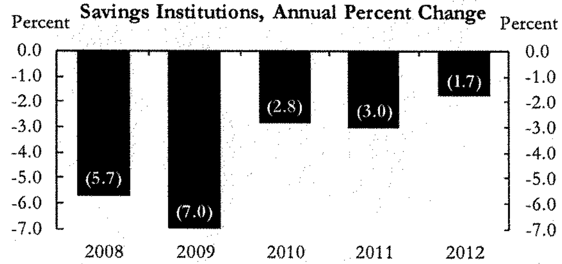
- Privatized, adequately-capitalized mortgage guarantee businesses and government reinsurance provide a bridge to a stable mortgage system without risking a sudden reduction in mortgage credit that would depress house prices and risk another recession

✓ **Ensures affordability**

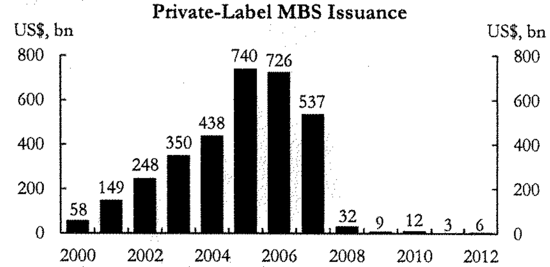
- Mortgage credit will be available during times of stress, long-term fixed-rate mortgage products will be available for most Americans, lending standards can normalize, and funding for affordability initiatives is transparent

A Transition Plan Must Be Realistic About the Availability of Private Capital

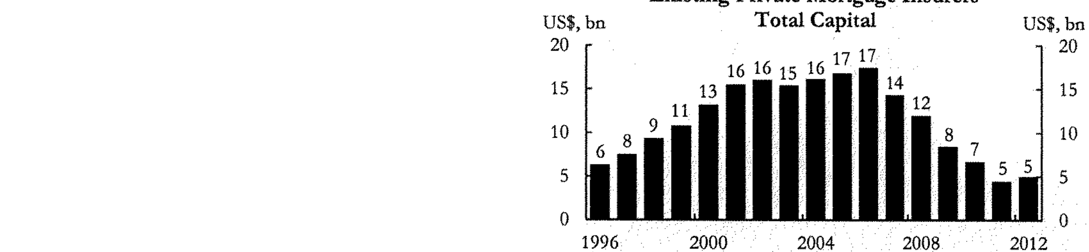
Residential Mortgages Held by Commercial Banks and Savings Institutions, Annual Percent Change



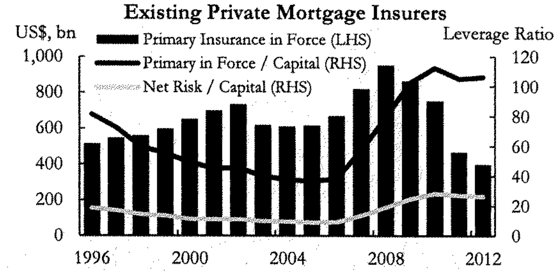
Private-Label MBS Issuance



Existing Private Mortgage Insurers Total Capital



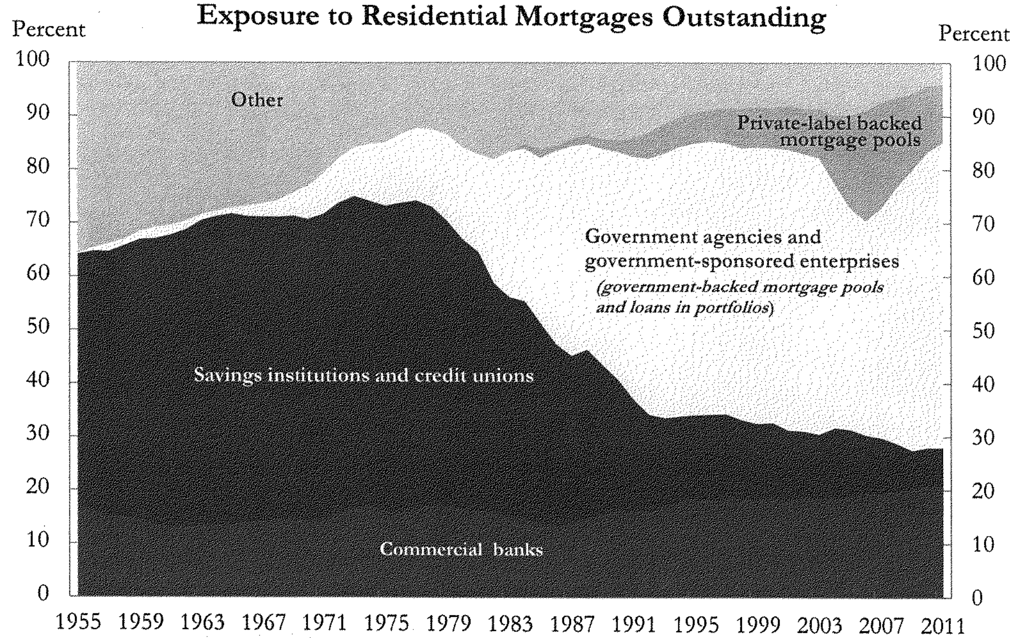
Existing Private Mortgage Insurers



Sources: Federal Reserve Board; Securities Industry and Financial Markets Association; Mortgage Insurance Companies of America; company reports; Millstein & Co. calculations.
Notes: End-of-year 2011 and 2012 estimates include Mortgage Guaranty Insurance Corp., Radian Guaranty Inc., and Genworth Mortgage Insurance Corp. Prior to 2011, estimates also include PMI Mortgage Insurance Co., United Guaranty Corp., and Republic Mortgage Insurance Co.

A Transition Plan Must Be Realistic About the Availability of Private Capital

Exposure to Residential Mortgages Outstanding

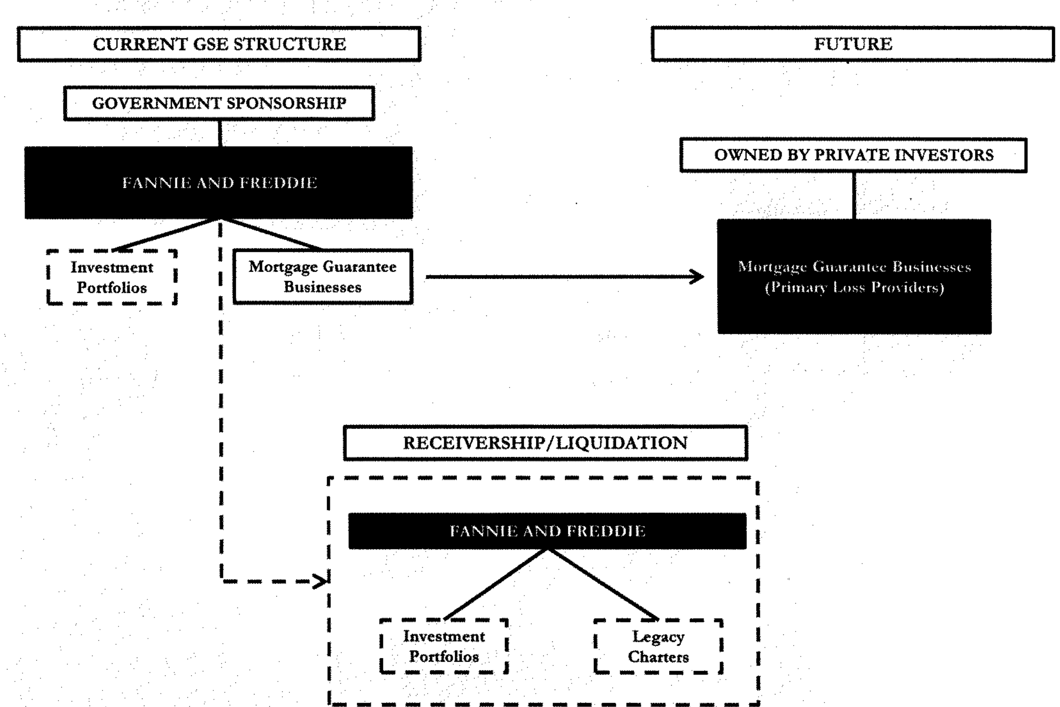


Source: Federal Reserve Board.
Notes: Other includes life insurance companies, finance companies, real estate investment companies, private pension funds, state and local government retirement funds, households and nonprofit institutions, and non-financial corporate and non-corporate businesses.

Where Does Capital Come From? Recapitalization to Privatization

1. **Use Fannie and Freddie earnings under conservatorship to build capital to protect taxpayers on guarantee businesses**
   - Raise the guarantee fees that they charge on MBS, which will have the collateral benefit of attracting private competition
   - Turn off the dividend on Treasury's Senior Preferred Stock
     - The current dividend requires the entities to remit any earnings to Treasury, which (i) leaves no capital in the institutions to absorb future losses, (ii) perpetuates the conservatorships, and (iii) enshrines Treasury's guarantee and effective nationalization of Fannie and Freddie and the secondary mortgage market
2. **Continue wind down of legacy investment portfolios and indebtedness**
3. **Contribute enterprise infrastructure to a new securitization utility for qualified MBS**
4. **Once the guarantee businesses have adequate capital, charter them as state corporations**
   - No special privileges
   - Along with other adequately-capitalized private MBS insurers, they can apply for a license from a new government reinsurer
5. **Recover taxpayers investments**
   - As Treasury did with AIG, Treasury converts its preferred stock to a substantial majority of the restructured companies' common stock and divests its stake over time in the public equity markets
6. **Repeal GSE charters and complete wind down of legacy investment portfolios and indebtedness**

Where Does Capital Come From? Recapitalization to Privatization



Recapitalization to Privatization – Supporting Detail

- **If policymakers implement this plan, Treasury could recoup $150 billion from selling its stake in the reorganized and privatized first-loss providers into the market over time**
  - Assumes privatized mortgage guarantee businesses charge 75 basis points (bps) to guarantee MBS, 10 bps go to the FMIC for reinsurance, and normalized expenses are 6 bps (net 59 bps of guarantee income)
  - Assumes guarantee books decline 10 percent
- **That would be $28 billion more than Treasury's current net investments in the companies**
- **Projected proceeds from the sale of Treasury's stake would be scored as deficit reducing immediately**
- **Fannie and Freddie are already demonstrating significant earnings potential**

HYPOTHETICAL FUTURE LOSS PROVIDER ANALYSIS			
$ in billions	NewCo 1	NewCo 2	Total
Size of Guarantee Book	$2,542	$1,558	$4,100
Net Guarantee Income, % of Book	0.59%	0.59%	0.59%
Guarantee Income	**$15**	**$9**	**$24**
Size of Liquidity Book	$75	$75	$150
Fee Income	**$0**	**$0**	**$1**
Size of Multifamily Book	$225	$160	$385
Investment Income, % of Book	0.60%	0.60%	0.60%
Multifamily Income	**$1**	**$1**	**$2**
Normalized Provision Rate	(0.05%)	(0.05%)	(0.05%)
Normalized Provisions	**($1)**	**($1)**	**($2)**
Taxes - 30% assumed rate	(5)	(3)	(8)
Net Income	**$11**	**$7**	**$18**
Assumed Valuation Multiple	10.0x	10.0x	10.0x
Implied Market Capitalization	**$108**	**$68**	**$176**
Treasury Ownership	85.0%	85.0%	85.0%
Treasury Share	**$92**	**$58**	**$150**
% of Net Investment as of Q1 2013	*114%*	*139%*	*123%*

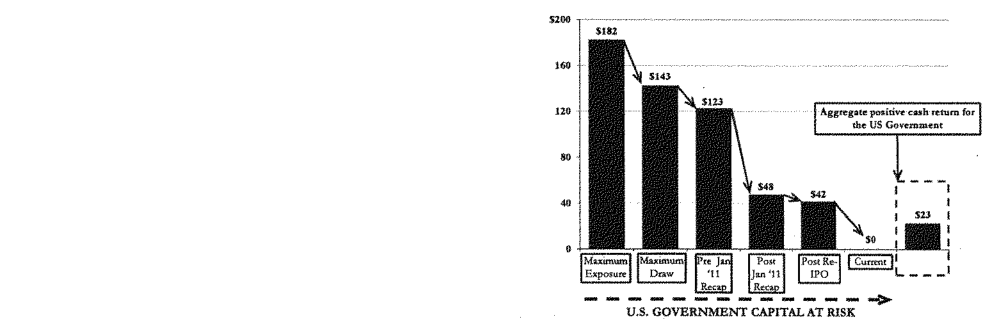
  - FHFA projects more than $60 billion of additional repayments to Treasury from net income through 2015 (exclusive of potential deferred tax asset write-ups and reserve releases)
- **Retained earnings would allow the companies to build substantial private capital ahead of FMIC reinsurance**
  - The restructured businesses could build to Tier 1 Capital levels that comply with Basel III standards imposed on banks
- **Private shareholders provide initial capital base into which Treasury can dispose of its common equity stake over time**
  - UST successfully used this approach to sell its common equity in AIG at a profit for taxpayers

AIG Case Study

At the height of the financial crisis in the Fall of 2008, the Federal Reserve Bank of New York ("FRBNY") and U.S. Department of the Treasury ("UST") provided massive credit and capital support to AIG in order to prevent the destabilization of the global financial system that would have resulted from AIG's collapse

Sep. 2008	Nov. 2008	Mar. 2009	Nov. 2010	Jan. 2011
FRBNY initially provides an $85 billion, high interest rate credit facility to AIG, which requires several restructurings in order to effectively support the company, the financial system and protect committed taxpayer capital	UST invests $40 billion of TARP funds in cumulative preferred stock in the company and the FBRNY established Maiden Lane II and III in order to buy troubled assets from the insurer at discounted prices	Cumulative preferred stock converted to non-cumulative preferred, to maintain necessary credit ratings for the core insurance operations and avoid a potentially disastrous liquidation process	Sale of the two largest non-core assets completed, with the sale of ALICO to MetLife and the IPO of AIA on the Hong Kong Stock Exchange, which raises a combined $36 billion in proceeds	Completion of a comprehensive recapitalization of AIG, including the repayment of all FRBNY obligations and **the conversion of UST preferred stock to 92% of AIG common stock**

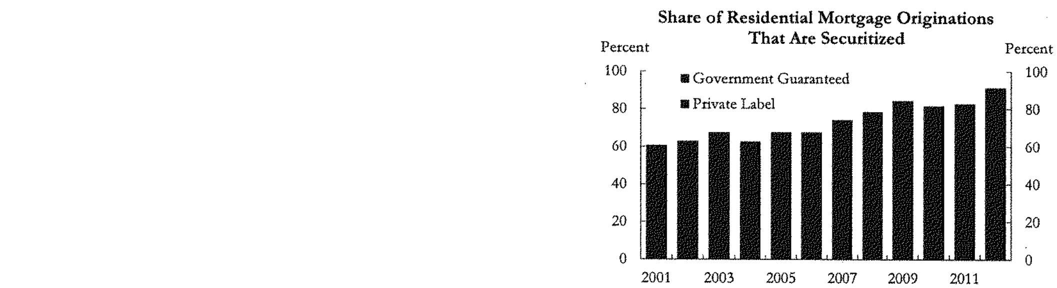
Government Exit Path

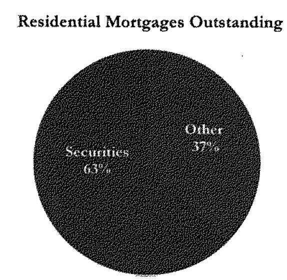


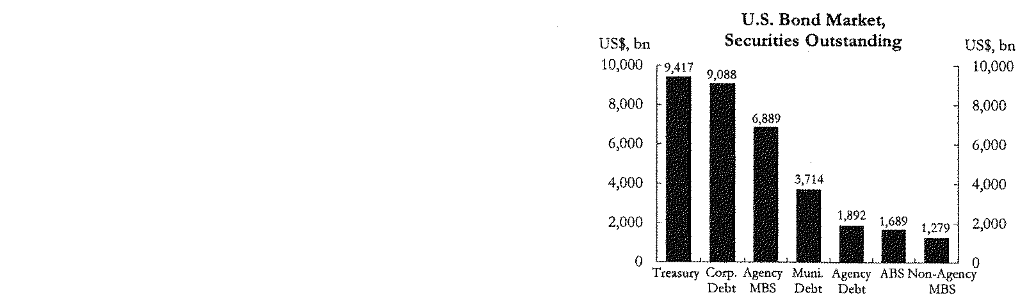
Recovery for Taxpayers Post Recap

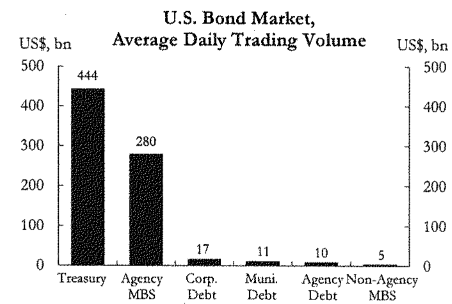
- **UST's $20 billion of preferred equity interests were completely repaid.**
- **UST sold its common ownership stake in AIG in six public offerings that generated $52 billion in proceeds for taxpayers**
- **At the height of the financial crisis, loss estimates on the government's investments in AIG were as much as $36 billion at the Congressional Budget Office (CBO) and $50 billion from the Office of Management and Budget (OMB)**
- **However, UST realized a significant profit on its original invested capital**
- **Including $19 billion of interest and dividends received, the U.S. government as a whole recovered the entire capital outlay, plus nearly $23 billion of cash profit**

The Government Cannot Abandon Housing Finance Without Putting the Depth and Liquidity of Housing Finance Markets At Risk









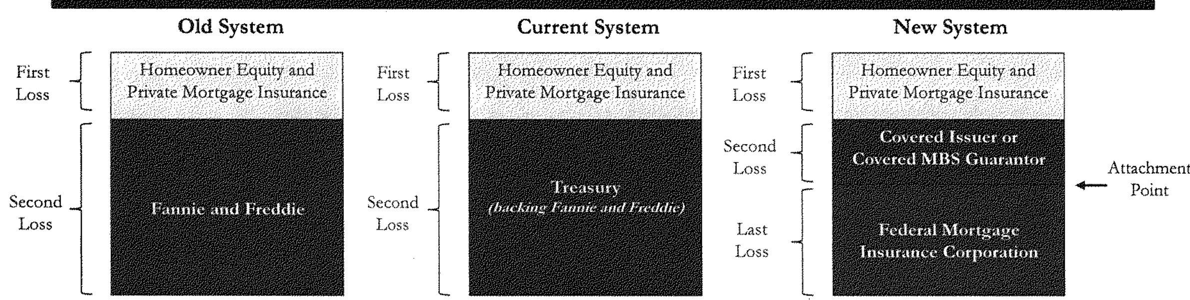
Sources: Inside Mortgage Finance; Securities Industry and Financial Markets Association; Federal Reserve Bank of New York.

Notes: One-to-four family mortgages. Securitized origination estimate for 2012 reflects annualized data. Treasury, agency and corporate debt estimates exclude issues of one year or less. MBS includes both residential MBS and commercial MBS. Outstanding bond estimates based on data through December 31, 2012. Trading volume estimates for 2012.

How is the New Government Guarantee Delivered?

- **A Federal Mortgage Reinsurance Corporation (FMIC) sells reinsurance on qualified mortgage-backed securities**
  - Homeowners and private mortgage insurers remain first in line for losses
  - Properly-capitalized issuers and MBS guarantors are second in line for losses on pools of covered mortgages up to an attachment point set by the FMIC
  - The FMIC is last in line for losses and will make up shortfalls in payments to MBS investors

Loss Sharing



Old System

- Fannie and Freddie guaranteed conforming mortgages
- The government implicitly guaranteed Fannie and Freddie
- The government did not charge for that implicit guarantee and did not have a mechanism to absorb losses if it was triggered
- **There was little private capital protecting taxpayers**

Current System

- Fannie and Freddie continue to guarantee conforming mortgages
- Treasury provides an explicit backstop for Fannie and Freddie
- Dividends from Treasury's investments go to the general fund, leaving taxpayers exposed to future losses at the enterprises
- **There is no private capital protecting taxpayers**

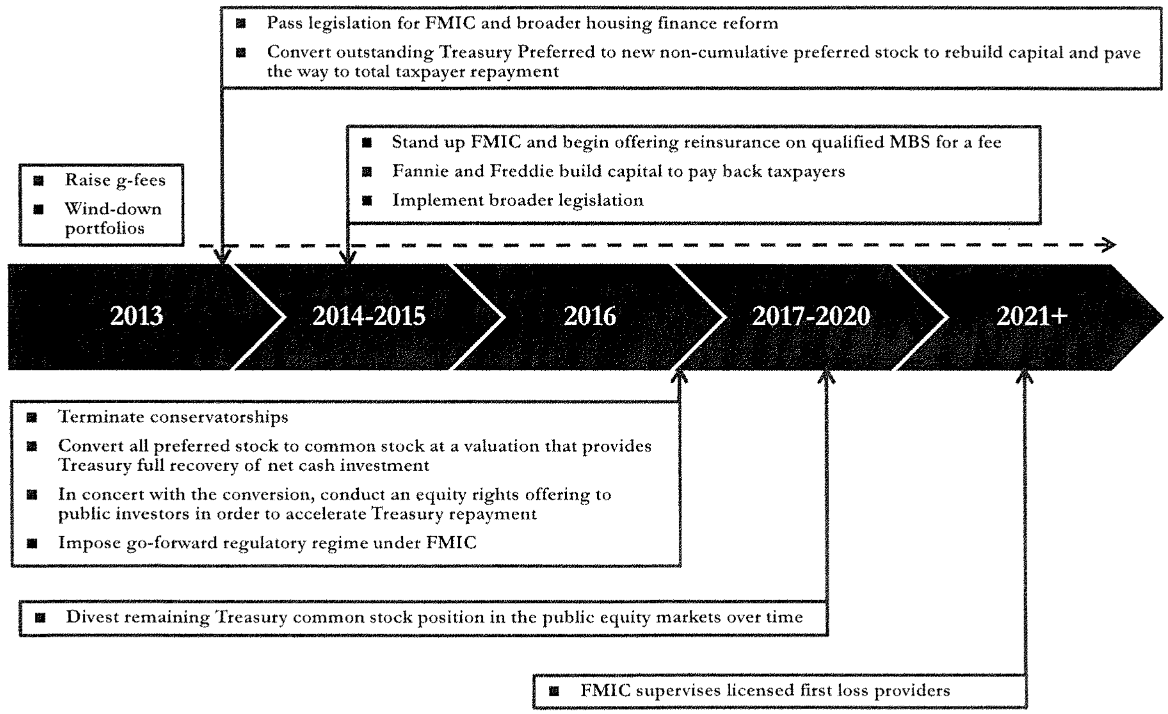
New System

- A private covered issuer or covered MBS guarantor is required to absorb losses up to an attachment point
- The FMIC provides explicit reinsurance on the covered MBS
- The FMIC charges a fee for its reinsurance and, like the FDIC, places proceeds in a strategic reserve fund
- **There is substantial private capital protecting taxpayers**

The Federal Mortgage Insurance Corporation (FMIC)

- **Establish the FMIC within the FHFA with a limited mandate**
  - Ensure stable credit for the housing system and protect taxpayers against loss
- **Three functions to accomplish mandate**
  1. Establish standards for qualifying mortgage products and practices
  2. Sell reinsurance for MBS comprised of mortgages that meet conservative underwriting and disclosure standards
  3. Supervise participating MBS securitizers and new private MBS insurers for safety, soundness, and capital adequacy
- **Independent agency with strong firewalls against political interference**
  - It must be insulated against political interference on the model of the Federal Deposit Insurance Corporation (FDIC), with a budget off limits for any purpose beyond its limited mandate and funded through fees set at arms length
- **Securitizers and private MBS insurers are first in line to cover losses and forced to hold capital adequate for their risks**
  - Capital standards must be consistent for all first-loss providers – no room for regulatory arbitrage
- **The FMIC would charge a fee to guaranty incremental shortfalls**
- **Similar to FDIC Deposit Insurance Fund, fees collected by the FMIC would be placed in a reserve fund that builds over time and only used to absorb losses**
- **The FMIC can decrease its role in the market over time by lowering the attachment point for its reinsurance**
- **Successful precedent**
  - FDIC, Terrorism Risk Insurance Act, Florida Hurricane Catastrophe Fund, Japanese Earthquake Reinsurance Co.

Transition Timeline



Remove Obstacles to Private-Label MBS Markets

- **Disclosure**
  - Loan-level information should be published for mortgages in all securitized pools
  - A new Mortgage Electronic Registration System (MERS) should be established
  - Deal documents for all MBS should be disclosed
  - Servicing would also be improved from additional disclosure, including performance and servicing fees

- **Enforcement**
  - The Trust Indenture Act should be amended to apply to MBS or it should be replicated for MBS
  - The FMIC should work with industry to establish standard pooling agreements with model representations and warranties as a non-waivable minimum
  - The new MERS should address transfer of title defects
  - A model non-judicial foreclosure law should be drafted and implemented

- **Inter-Creditor Rights**
  - The FMIC should establish a new inter-creditor regime for mortgages
  - First lien investors should have rights to approve second liens that would lead to an unsustainable combined LTV
  - Second lien holders should not be paid before the first lien holder without consent
  - First lien holder should control the restructuring or foreclosure process
  - Loan-level losses must be properly allocated in the pools, and junior lien holders should be impaired first

- **Servicing**
  - The FMIC should establish and enforce rules to eliminate conflicts of interest in servicing and to improve processes for restructuring mortgages
  - Bar second lien holders from servicing first liens, which would also stimulate servicing competition
  - Sever servicer relationships that undermine investor rights, increase transaction costs, and hurt borrowers
  - Modify servicer compensation
  - Establish uniform accounting policies and procedures for loan servicing and restructuring

Note

We may purchase and sell securities, derivatives and other instruments issued by one or more entities which are the subject of this report and may currently or in the future provide advisory, investment banking and other securities related services to such entities and to investors in the securities issued by such entities.

- Millstein & Co., LLC

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U.S. House of Representatives Committee on Financial Services hearing, "Building a Sustainable Housing Finance System: Examining Regulatory Impediments to Private Investment Capital."

April 24, 2013

<u>Question and Response for Official Hearing Record</u>

Representative Bill Foster (D-IL):

1) In your testimony you recommend giving first lien holders the ability to require their consent to a second lien if the combined LTV with all other liens will exceed 80%. Do you recommend applying this principle retroactively?

Response from Martin S. Hughes:

I do not recommend applying the requirement retroactively. The practical difficulties of a retroactive application would be very high, and since 15% -20% of the mortgage market turns over annually, the benefits of my recommendation can be achieved fairly quickly prospectively with a reasonable transition.

AMI ASSOCIATION OF MORTGAGE INVESTORS

Questions for the Committee Hearing Record

Congressman Bill Foster

House Financial Services Committee Hearing

"Building a Sustainable Housing Finance System:

Examining Regulatory Impediments to Private Investment Capital"

Question:

During your testimony you advocated for a "light hand of government" with respect to the standardization of mortgage products. Can you elaborate on how you view the government's role in creating and enforcing standardized securitization products should be permitted? Can you also talk about the FHFA's single-securitization platform and how it might benefit the PLS market?

Answer:

The Association of Mortgage Investors (AMI) appreciates the opportunity to respond to questions on the record to supplement our Committee hearing testimony. AMI's investors believe that the federal government has a role in setting minimum standards, systems, and structures for the efficient functioning of the capital markets. The government's standard-setting role will ensure banking entities issue quality mortgage products and protect Residential Mortgage-Backed Securities (RMBS) investors, including our partners from public pension funds, retirement systems, and endowments. In our written testimony, we outline some long standing defects of the current RMBS system, which in part, lead to the recent financial crisis; prevent private capital from returning to the mortgage market; encourage costly and time-consuming putback litigation surrounding the breach of contracts; and, limit the availability of mortgage credit for borrowers. Per our written testimony (pages 2 -3), the defects of the current RMBS system include:

- Lack of Transparency concerning basic loan information;
- Poor loan underwriting standards;
- A lack of standardization and uniformity concerning the transaction documents;
- Numerous conflicts-of-interest among servicers and their affiliates;
- Antiquated, defective, and improper mortgage servicing practices;
- An absence of effective legal remedies to investors for violations of RMBS contractual obligations and other rights arising under state and federal law; and,
- Unwarranted federal and state government intervention in the mortgage market (*e.g.*, the use of eminent domain as a foreclosure mitigation tool).

The situation with the current RMBS market is very analogous to the 1920s corporate bond market collapse. In response, Congress enacted the Trust Indenture Act (TIA), which reformed many of these defects, through standard-setting and establishing investor rights. Today, observers note that the U.S. corporate bond market functions extremely well due to the TIA. The government's role in creating and enforcing standardized securitization products should be permitted through legislation and the agency regulatory efforts, such as FHFA's suggested single-securitization platform. In essence, mortgage investors seek a Trust Indenture Act for the RMBS market. The precise benefits for investors and consumers from such legislation is detailed in our written statement (pages 12 - 16).

AMI believes that the FHFA single-securitization platform is a positive development for the industry, including setting some basic standards for industry participants. It is our hope that FHFA's platform is open access such that it may become the standard for the PLS market and not merely for the agency mortgage market. Currently, the PLS mortgage market is virtually non-existent, as we describe in our written statement.

Thank you for the opportunity to respond to your questions on the record. Please do not hesitate to use AMI as a resource going forward.

To: Congressman Foster
From: Arnold Kling

Re: follow-up questions

1. What is the experience of other countries using the Torrens title system? What would it save American consumers?

The Torrens system was developed in South Australia.[1] It is in use in many British Commonwealth countries, including Canada, and in Europe.[2]

With the Torrens system, consumers would not have to pay for a title search and title insurance.

For consumers, the cost of a title search and title insurance varies by state. I recently found an estimate that for a $200,000 loan in Maryland, the title search and insurance would cost $1400, while in New York the cost would be $2800.[3]

Assuming 5 million mortgage transactions per year and a cost of $1500 per mortgage, eliminating the need for title search and title insurance would save American consumers $7.5 billion per year.

Moreover, the current title system is fundamentally incompatible with mortgage securitization. Many of the legal problems that emerged with foreclosures in recent years, including "robo-signing," can be traced to the difficulties with reconciling a fast-paced, centralized, computerized mortgage security trading system with a fragmented, paper-based title system.

At the hearing, other witnesses argued for standardized loan servicing contracts that clarify investor rights and servicer responsibilities. This might prove difficult to achieve with our current title system.

2. What about the Danish model, in which mortgages are converted into callable bonds?

The Danish model has many attractive features. However, it deals with credit risk by requiring a minimum 20 percent down payment. That makes it unlikely that U.S. policy makers would be willing to import the Danish model, unless more legislators can be convinced that a stable housing market is more important than maximizing opportunities for home purchase.

Germany uses a similar mortgage financing system known as "covered bonds," in which banks issue bonds that are collateralized by the underlying mortgage loans. That system would be more easily adapated here.

A point that I need to stress is that the interest-rate risk on mortgages has to go somewhere. We know

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1 http://www.sa.gov.au/subject/Housing,+property+and+land/Information+about+properties+and+places/Historical+searching+and+information/Torrens+titles

2 http://legal-dictionary.thefreedictionary.com/Torrens+Title+System

3 http://www.bankrate.com/finance/mortgages/2012-closing-costs/united-states.aspx?ec_id=m1106820&ef_id=MAdOTX@mtvkAAMAZ:20130508233746:s

that if banks take on this risk, then that can work out badly, as the experience of the Savings and Loans in the 1970s illustrates.

However, getting the risk out of the banks may not work out well, either. Banks can off-load the risk by issuing pass-through securities or by issuing callable debt, but someone has to be on the other side of these transactions. The institutions that buy these instruments will inherit the embedded risk. Just as no one knew until September of 2008 that the financial products division of AIG insurance was a key player in mortgage credit risk, we may not know until there is an interest-rate shock which institutions have major maturity mismatches or large positions in interest-rate swaps or other derivative contracts. It may well turn out that these institutions are "systemically important" or "too big to fail," in which case an interest-rate shock will cause taxpayers to be summoned to the rescue.

If regulators are able to ensure that interest-rate risk stays in the private sector, and if mortgage lenders are free to price different mortgage products based on risk, then we are likely to see a high interest rate on thirty-year fixed-rate mortgages relative to other products. This will induce consumers to choose shorter-term loans. I would not want to see consumers driven into one-year or three-year adjustable-rate products. However, I think that a thirty-year mortgage with a rate fixed for five or ten years is a reasonable balance of interest-rate risk between lenders and borrowers.

May 20, 2013

Committee on Financial Services
Hearing Entitled "Building a Sustainable Housing Finance System: Examining Regulatory Impediments to Private Investment Capital"

Questions for the Record – James Millstein

<u>Representative Foster</u>: In your testimony you advocated for the standardization of mortgage products. Can you elaborate on how you view the government's role in creating and enforcing standardized securitization products and how much private sector innovation should be permitted? Can you also talk about the FHFA's single-securitization platform and how it might benefit the PLS market?

The federal government can and should play a constructive role in promoting standard securitization products. The recent crisis demonstrated that heterogeneity combined with complexity in securitized mortgage products undermined investor confidence in the asset class, leaving the government as the only willing buyer of credit risk over the past five years. Promoting standard pooling and servicing agreements, basic investor protections such as those incorporated in the Trust Indenture Act, clear priorities between first and second lienholders, and minimum disclosure requirements for securitized mortgage products would facilitate a system that provides investors and borrowers with more certainty at all points in the economic cycle. That certainty increases the likelihood that private investors will return to the mortgage market in size and to take credit risk during the next downturn.

We have witnessed the benefits of standardization in other markets over the past 70 years. The Trust Indenture Act of 1939 established a uniform legal regime between corporate bond issuers and trustees to protect investors who had been burned by weak and heterogeneous rights and bond instruments during the Depression. The Securities Act of 1933 established standard disclosure requirements that allow private investors to evaluate companies on equal footing and with confidence in the accuracy of the published information. Today the US has the largest, most liquid and resilient corporate bond and equity markets in the world.

However, there must be a balance between standardization and room for competition and innovation. New mortgage products should be permitted as long as their features are adequately disclosed to borrowers and investors, and as long as regulated financial companies who hold such products are adequately capitalized against the risks that they pose. As adoption becomes widespread, the government should promote standardization of those mortgage products.

Further, the government should not establish standards for securitized mortgages in a vacuum. It should work closely with borrower, lender, servicer, and investor groups to develop standards that are not only theoretically sound but also workable and sensible in practice. The government should also eliminate differences in mortgage contract and reporting requirements across agencies.

In my proposal, the Director of the Federal Mortgage Insurance Corporation (FMIC) would be authorized to promote standard securitization products. The Director would establish and enforce standards for mortgage-backed securities (MBS) that qualify for FMIC reinsurance. The Director would also enforce a new trust indenture for MBS.

The single-securitization or common securitization platform (CSP) currently under development at Fannie Mae and Freddie Mac could serve as a utility for all market participants. Initially, it would likely be targeted at conforming MBS, allowing the enterprises to invest in a joint backend system and to standardize the interface with lenders. That should eventually lower operating expenses for all participants in the conforming market. The CSP is attempting to establish an industry advisory group that would be similar to the Treasury Borrowing Advisory Committee. As discussed above, such a group would increase the likelihood that the CSP would be useful across the market, including potentially for private-label securities (PLS) issuances.

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Submission for the Record by the Securities Industry and Financial Markets Association

House Committee on Financial Services

Hearing entitled "Building a Sustainable Housing Finance System: Examining Regulatory Impediments to Private Investment Capital"

April 24, 2013

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Introduction

SIFMA is pleased to present this statement regarding impediments to the return of private capital funding mortgage credit for the record of the Committee's April 24 hearing. In 2010, SIFMA[1] submitted a response to a request for comments from the Department of the Treasury regarding reform of the housing finance system. This testimony serves as a "Where are we now?" update to SIFMA's response of three years ago.

SIFMA's members strongly desire the restoration of significant levels of private capital participation in mortgage credit. Our members want a mortgage market that balances access to credit with prudence and stability. A 100% government guarantee for over 99% of mortgage-backed security issuance is neither prudent nor a sustainable way to fund access to housing in this country. However, a prudent and stable mortgage market is essential so that the vast amount of economic activity that is related to housing may support the economy and job creation.

The current housing finance system began in the 1930s. A complete overhaul of a system 80 years in the making is a very large task which will take years, if not decades, to accomplish. SIFMA members believe this overhaul will be best accomplished through a series of incremental steps that invite greater amounts of private capital to participate in taking meaningful credit risk, while preserving the liquidity and beneficial components of the market such as the To-Be-Announced market.[2] As we will discuss below, the level of fundamental change market participants have already been required to process is straining infrastructure and limits the capacity to institute more change.

A critical step remains the establishment of a national goal by policymakers who will determine the future of these markets. As we said in 2010,

> *"There is no single "right answer" or any easy solution to the question of how to resolve the conservatorships of the GSEs and define the future infrastructure for mortgage finance in the U.S. Policymakers are faced with a series of difficult choices, each with its own costs and benefits, which will shape the future of housing finance. Ultimately, this essential infrastructure is both a creation of and a reaction to past public policy choices, and as such the future of it will grow out of further determinations of what is the appropriate public policy regarding mortgage finance."*

There is a clear desire for private capital to more frequently stand in a first-loss position, but beyond that there remain many views on the appropriate role of the government in mortgage finance and the standards for access to mortgage credit. There are also many uncoordinated regulatory efforts where the aggregate impact is not, and by definition cannot be accurately estimated. While the stated purpose of most of these efforts is to make the markets safer and more transparent, we are concerned that consideration has not been given to functionality of the industry when re-regulation is completed. The most serious danger is that at some point the pace of change

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.
[2] For an overview of the To-Be-Announced (TBA) markets, please see SIFMA's TBA Market Fact Sheet, available here: http://www.sifma.org/workarea/downloadasset.aspx?id=23775

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may cause the mortgage finance system to fail; it is unclear if the system would then be able to offer a viable mortgage product to borrowers.

The Need for Market Participants to Understand the Rules of the Road

For the last five years the rules for lending, securitization, investing, capital, and trading have been in a state of constant change. Market participants make capital allocation decisions based off of a set of facts and expectations at a given point in time; this is difficult when facts and expectations change regularly. Lenders and securitizers need to know that securitization is a long-term funding option so that they can build their businesses around it. Currently, there are many concerns for lenders as to the value of MBS as a funding strategy. The question is whether securitization will be economically attractive compared to funding alternatives such as deposits or debt issuance. If it is not, we believe that the ability of the market to fund credit creation will be severely impaired.

- Understanding future size and scope of the government guaranteed market will allow originators to be in the best position to determine longer-term lending strategies.
- The TBA MBS market plays a critical role in providing market participants the ability to hedge interest rate risk and sell loans into a liquid forward market. The liquidity of this market is fostered through the guarantees provided to MBS that trade in it; while the appropriate size and nature of future government involvement is yet to be decided, SIFMA believes that implementation of reforms should involve consideration of their impact on the liquidity of TBA markets.
- A degree of certainty has been granted by the promulgation of the Qualified Mortgage (QM) final rules, but lenders and investors are still working through their implications. They will not be effective until 2014, so the examination and enforcement regime is unclear -- but very important.
- The "Qualified Residential Mortgage" (QRM) rule proposal, when finalized, will determine the types of mortgages that have the least capital-intensive funding available, and may tend to be the mortgages of choice for many lenders, especially those who are less capitalized.
- The "Premium Capture Cash Reserve Account" (PCCRA) provisions of the risk retention rules, as proposed, would require a securitizer to retain in a first loss position all proceeds in excess of the par value of the loans for the life of the transaction. Under current accounting guidance, application of PCCRA would effectively restrict the ability to receive sale treatment in capital markets transactions for mortgage loans. This will render many transactions uneconomical, and harm borrowers by restricting their ability to lock rates, finance closing costs and obtain other features borrowers traditionally enjoy. PCCRA should be eliminated.
- SIFMA's sponsor, issuer, and dealer members are concerned that the application of public-style disclosure rules to privately issued securitization transactions (i.e. those issued pursuant to Rule 144a) could limit the utility of securitization for many transactions. However, Regulation AB2 has not been finalized so the future is uncertain.
- The U.S. implementation of the Basel III capital rules could significantly impact the capital cost of mortgage lending and servicing, and put U.S. banks at a competitive disadvantage to foreign banks. The revisions to the Basel Securitization Framework, which are currently in the discussion stages in the Basel Committee, may entirely eliminate the economic utility of various kinds of securitization.

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We also note and commend the strategic goal of the FHFA to modernize and develop a common securitization platform for the activities of the GSEs. As we understand the effort, the FHFA is directing the GSE's to coordinate an upgrade of their infrastructure so that they will have a common method of conducting business. This initiative will make the mortgage finance system more efficient and save the taxpayer money. We believe that a better understanding of the longer-term goals for this initiative and public comment thereon is appropriate; any significant changes to the nature of interaction with the GSEs will have broad impacts on both lenders and investors in MBS. In particular, if the goal is to facilitate credit risk intermediation within the private sector, further input on both the physical infrastructure and corporate governance of the new organization is necessary. In particular, we believe that private capital is unlikely to use this organization to its fullest extent if meaningful ownership and corporate representation are not made available to the private sector.

The Need for Investors to Have Faith in Products, Practices and Government Policies

Investors must regain confidence in the products, processes, and importantly the stability of government policies at the state and federal level before they will put significant debt capital at risk. It is not true that simply because mortgage assets are for sale an investor will buy them at a price that creates a mortgage rate that is attractive to the mortgage borrower, especially in the context of the size and funding needs of the U.S. mortgage market, which is larger than all European markets combined. We must create an environment that promotes strong investor interest in mortgage securities.

Mortgage investors have endured significant economic losses over the last five years and remain wary of both private mortgage securitization and GSE MBS.[3] They have demonstrated their preference for other asset sectors in the last several years, leaving mortgages more expensive than they otherwise could be.

It is important to note that many of these investors are large institutional investors who invest on behalf of pension funds, mutual funds, 401(k) plans, and other vehicles that channel the savings of ordinary Americans into the financial markets. They represent at an aggregate level the American public, and it is clear to SIFMA that their confidence has not been restored in mortgage securitization. We outline a number of important issues below that remain to be embedded into policy and implemented:

- Understanding future size and scope of the government guaranteed market will allow investors to be in the best position to determine longer-term allocations to the non-agency MBS sector.
- Similar to lenders, investors are active in the TBA MBS market and value its vast liquidity and ability to obtain exposure to interest rate risk as opposed to credit risk. This ability is foster by the guarantees on the securities that trade in this market. The importance of this market to investors must be recognized in consideration of reforms to the role of the government in mortgage finance.
- Events or actions that upend investor expectations should be avoided. Policy stability is a prerequisite to fostering a large and vibrant market. Investor participation in the policy development process is essential to their future engagement in the securitization markets.

[3] Among other issues and depending on the type of investor, uncertainties around the guarantee, changes to market dynamics due to quantitative easing, and the general low yield environment.

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- Investors will demand greater loan level disclosure regarding the mortgages that underlie MBS. Reliance on ratings agencies has been reduced. SIFMA investor members support the SEC's proposed disclosure and offering process reforms found in Regulation AB 2.
- Going forward, we expect transaction structures to be simpler, and expect investors to demand greater standardization of structures and documentation. The roles of trustees and other transaction parties will need to be more clearly defined in future transactions.
- Clarifying the ability of investors to enforce the terms of the transactions has become a critical focus of both investors and issuers. In our response to the SEC's proposed Reg AB2 in 2010, our issuer and investor members worked together to develop a regime whereby a third party would serve as a monitor and agent of the investors in the transaction.[4] Some recent securitization transactions have included a similar mechanism and we expect this will continue.
- Lien priority of secured, first lien creditors has been an issue of much contention as loss mitigation efforts have expanded, and will need to be addressed in order to maximize private capital participation in funding mortgage credit.

Conclusion

Investors have suffered significant losses which call into question their desire to participate in mortgage markets. Issuers and originators face daunting uncertainty regarding what products they will be able to produce, how much they will cost, and more generally their business models. Each of these creates a drag on the functionality of mortgage finance markets, and diminishes the level of participation of both investor and lender capital in mortgage markets. We need to set the stage so that private capital desires to return to these markets.

The Committee is rightly focused on reviewing regulatory and legal impediments to this happening, as these are areas where Congress and regulators can play a key role. Other aspects of this problem, such as redeveloping confidence in non-guaranteed residential mortgages as an asset class for investment, can be partially addressed though regulation or legislation, but will also require time and experience with current and new issuances.

In any case, solutions developed in a closed process, where critical participants cannot share their views, are unlikely to be successful. It is critical that policymakers and market participants – all stakeholders including investors, originators, and securitizers – participate in the reformation of the mortgage finance markets.

We applaud the Committee's consistent interest and efforts to create a discussion in this area; SIFMA stands ready to assist the Committee with its work.

[4] Please see page 6 in SIFMA's August 2010 letter for a full description of the proposed regime, available here: http://www.sifma.org/issues/item.aspx?id=914

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Annex: Summary of Specific Legal and Regulatory Impediments to Securitization

"Premium Capture Cash Reserve Account" (PCCRA) Provisions in the Risk Retention Rule Proposal (Dodd-Frank Section 941) [5]

Impediment

- The "Premium Capture Cash Reserve Account" (PCCRA) provisions of the risk retention rules, as proposed, would require the securitizer to retain as a first loss position all proceeds in excess of the par value of the loans, for the life of the transaction. This will render many transactions not economical for the issuer, and will likely restrict the ability of the borrower to lock rates, finance closing costs and obtain other features borrowers traditionally enjoy.

Solution

- While SIFMA recognizes that the proposed premium capture provisions may have been proposed as a way to support the purposes of risk retention, the actual effect of the PCCRA has much broader and harmful consequences to consumers and securitization markets. SIFMA strongly recommends that the PCCRA be withdrawn from consideration.

Qualified Residential Mortgage Definition (QRM)[6]

Impediment

- The QRM will define a type of loan for which securitizers will not be required to retain risk. This definition has not yet been promulgated.

Solution

- SIFMA investor members broadly support the proposed definition of QRM as a narrower, extremely high credit quality gold standard.
- SIFMA's dealer, issuer, and sponsor members have advocated for a broader definition of the QRM, such that compensating factors would be allowed to be considered, and the QRM would better reflect the manner in which loans are underwritten.
- In any case, the contours of what is a QRM must be very explicit, and with bright lines outline what is, and what is not a QRM. Compliance with the rules must be readily ascertainable, and should not be called in to question after the fact.

[5] See SIFMA's June 2011 letter regarding the risk retention rule proposal, available here: http://www.sifma.org/workarea/downloadasset.aspx?id=25925, see also, SIFMA's January 2012 letter regarding the premium capture provisions, available here: http://www.sifma.org/workarea/downloadasset.aspx?id=8589937126

[6] Please the SIFMA Dealer and AMG letters regarding the risk retention proposal, available here: http://www.sifma.org/issues/item.aspx?id=8589935782 and http://www.sifma.org/workarea/downloadasset.aspx?id=25926

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QM[7]

Impediment

- While the QM rules have recently been finalized, much work remains as the industry assesses the rules. Further, the enforcement and examination process is not clear at this time.

Solution

- We hope that the CFPB will show flexibility, inclusiveness, and responsiveness to feedback, and be willing to calibrate various parameters of the rules prior to the implementation date. As industry participants work toward implementation of these rules, we expect there will be numerous areas that will require interpretation of clarification by CFPB.

Eminent Domain Abuse[8]

Problem

- Various municipalities are exploring the abuse of their powers of eminent domain to seize mortgage loans from private-label securitizations in order to force a refinancing of performing, but underwater, borrowers. If enacted, these plans would destroy investor confidence in securitization, and halt any hopes of returning private capital to mortgage markets. SIFMA has worked extensively around the country to educate policymakers and local officials as to the harm such plans would engender, as well as understanding how significantly the costs exceed any benefits of such action.

Solution

- If seizures are made and later determined to be defective, the damage will be done when the first loan is taken. It will not matter that they were ultimately determined to be illegal. The consequences to credit availability in the locality will be immediate, and great harm will be done to any progress towards weaning national markets off government support, as private investors will recoil in horror at the unprecedented abrogation of mortgage loan contracts.
- Congress, regulators, and the Administration should make clear their opposition to such plans, and take steps to ensure these unconstitutional and ill-advised policies are not implemented.

[7] Please see SIFMA's letter on the proposed Qualified Mortgage definition, available here: http://www.sifma.org/workarea/downloadasset.aspx?id=8589938566
[8] Please see SIFMA's Eminent Domain resource activity page, available here: http://www.sifma.org/issues/capital-markets/securitization/eminent-domain/activity/

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Basel III[9]

Impediment

- The rules proposed by Federal Bank Regulators to implement Basel III include significant changes to the regulatory capital regime for mortgages and mortgage servicing. If implemented, the rules could fundamentally reshape the mortgage market.

Solution

- The Agencies should eliminate the existing 10 percent haircut for mortgage servicing assets, increase the proposed 10 percent deduction threshold for mortgage servicing assets to 25 percent and grandfather existing mortgage servicing assets.
- Grandfather legacy mortgage exposures to reduce regulatory burden and data constraints.
- Evaluate first and junior lien mortgages separately so that a junior lien does not "taint" the first lien, unless the junior lien is originated and funded at the same time as the first lien in a "piggyback" loan.
- Recognize sustainable loan modifications and restructurings, whether or not they are a part of the Home Affordable Modification Program.
- Recognize private mortgage insurance at both the individual and the pool-wide level.
- Maintain the 120-day safe harbor for credit-enhancing representations and warranties in the current risk-based capital rules.

Basel Securitization Framework[10]

Impediment

- The proposed rules will make securitization so expensive that it will not be efficient to use securitization to finance mortgages and far less mortgage credit will be available. The increase will be several MULTIPLES of what the required capital is now. Preliminary calculations show the various methodologies are inconsistent with each other. No QIS has been done yet to demonstrate what the real world cost of the new rules will be.

Solution

- The process must slow down and a study be done of the results of the QIS.
- Less punitive capital levels should be proposed and calculation approaches should be better aligned.
- The capital for the various tranches of a securitization should not add up to much more than the pool's capital before it was securitized.

[9] Please see the SIFMA, ABA and FSR letter regarding Basel III, available here: http://www.sifma.org/issues/item.aspx?id=8589940758
[10] See GFMA's letter regarding revisions to the Basel Securitisation Framework, available here: http://gfma.org/Initiatives/Securitisation/GFMA-Submits-Comments-to-the-BCBS-on-Revisions-to-the-Basel-Securitisation-Framework/

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Volcker Rule[11]

Impediment

- SIFMA is concerned that the regulators' proposed definition of the term 'covered fund' sweeps in a wide range of entities, both domestic and foreign, that have never been considered hedge funds or private equity funds. This may render many beneficial types of securitization impossible for banks. The characterization of certain transactions as commodity pools by the CFTC will also create Volcker-related prohibitions and impact lender risk management capabilities.

Solution

- SIFMA believes that fully excluding most asset-backed securities issuers from the definition of covered funds is required to ensure the practical viability of banking entity securitization and insurance-linked securities transactions.

Dodd-Frank Act Section 621 (Conflicts of Interest) [12]

Problem

- The SEC's proposal to implement section 621 of the Dodd-Frank Act has the potential to prohibit certain kinds of beneficial, risk mitigating securitization transactions, and to impose very significant compliance cost burdens on securitizers, and in some cases could force financial institutions to chose between securitization and other activities, such as lending or investing.

Solution

- The SEC should amend the proposed rules that would implement section 621 in a number of ways, such that the SEC creates a framework to prohibit "designed to fail" transactions, while still allowing for the issuance of ABS without the uncertainty of over-broad or vague regulations or undue restrictions or prohibitions. SIFMA's more specific concerns and recommendations to the SEC regarding the implementing regulations are set forth in our comment letters.

Covered Bonds[13]

Problem

- SIFMA believes that covered bonds can play a limited, but important role in providing cost-effective funding for mortgage loans. However, this will not happen without a regulatory framework for the issuance and oversight of U.S. covered bonds, including the requisite clarity on

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[11] Please see SIFMA's February 2012 letter regarding the Volcker Rule and Securitization, available here: http://www.sifma.org/issues/item.aspx?id=8589937357, see also SIFMA's May 2012 letter proposing a specific exemptive framework for securitization, available here: http://www.sifma.org/issues/item.aspx?id=8589938859

[12] See SIFMA's letter to the SEC on the Section 621 rule proposal, available here: http://www.sifma.org/issues/item.aspx?id=8589937359

[13] Please see the June 2011 SIFMA and US Covered Bond Council letter to the US House Financial Services Committee on the United States Covered Bond Act of 2011, available here: http://www.sifma.org/workarea/downloadasset.aspx?id=26016

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investor's rights in case of an issuer's insolvency. In 2011, both House and Senate versions of legislation were floated, but neither progressed.

- Congress should pass legislation similar to that noted above, in order to allow a covered bond market to play some role in mortgage finance.

AMERICAN ACTION FORUM

Regulatory Reform and Housing Finance: Putting the "Cost" Back in Benefit-Cost

Douglas Holtz-Eakin, Cameron Smith & Andrew Winkler I October 2012

Introduction

The impulse for regulatory reform in the aftermath of the U.S. housing bubble is both understandable and appropriate. The housing bubble was characterized by under-regulation (mortgage origination) and over-regulation (the housing government-sponsored enterprises' excessive affordable housing goals). Getting the regulation of housing finance right was, and remains, a policy priority.

Getting regulation right means balancing benefits and costs. Even in ordinary circumstances, this laudable goal is difficult to realize in practice. Since the bubble burst in the housing market, there has been a virtual tsunami of changes to the environment facing the mortgage finance industry. Credit standards and minimum down payments have increased, and access to credit has become a challenge for even qualified buyers. Stringency in the private sector has shifted mortgage production to the government-sponsored enterprises (GSEs) and Federal Housing Authority (FHA), where the observed standards of originations have risen as well. The net result has been a visible drag on the housing market and the economy.

However, more regulatory impacts are in the offing with the implementation of Dodd-Frank legislation and the Basel III accords. These well-intended regulations proposed to shore up weaknesses in the mortgage finance system at the behest of Congress and the international financial community may go further than desired and risk undermining long-term growth in the housing market and U.S. economy.

This paper seeks to illuminate the regulatory debate by estimating the impact of recent regulation on mortgage origination, housing construction, and macroeconomic activity. We find using conservative economic assumptions that the bottom line effects of proposed Dodd-Frank and Basel III regulations may include up to 20 percent fewer loans, resulting in 600,000 fewer home sales. In turn, the resulting tightened lending and reduced sales are estimated to cost up to 1,010,000 housing starts, 3.9 million fewer jobs, and a loss of 1.1 percentage points from GDP growth over the next three years.

Summary Table: Impact of Dodd-Frank and Basel III Rules

	Housing Starts		GDP Growth		Employment	
	Baseline	*D-F & B3*	*Baseline*	*D-F & B3*	*Baseline*	*D-F & B3*
2012	770,000	770,000	2.2%	2.2%	133.3m	133.3m
2013	1,510,000	1,110,000	3.3%	2.5%	136.1m	135.4m
2014	1,560,000	1,250,000	3.0%	2.7%	138.8m	137.2m
2015	1,620,000	1,320,000	2.4%	2.4%	140.2m	138.6m

Regulatory Reforms and Housing Finance

Among the most important aspects of the regulatory environment are two parts of the Dodd-Frank (D-F) regulation that will impact the mortgage finance industry: the Qualified Mortgage rule (QM) and Qualified Residential Mortgage rule (QRM). The former defines standards for how mortgages can be originated. The latter defines the characteristics of mortgages that can be securitized and sold to investors without requiring that the securitizer retain 5 percent of the risk.

While some aspects of the QM and QRM will help to create the standards and safety needed to protect consumers and to draw private investors back to the mortgage-backed securities (MBS) market, others will overlay high costs and limit access to credit for a large number of potential borrowers in good standing, driving consumers from the private mortgage market. Looking under the surface, together these regulations contain six features that will limit future mortgage production for a broad swath of borrowers that includes those with the ability to repay a loan:

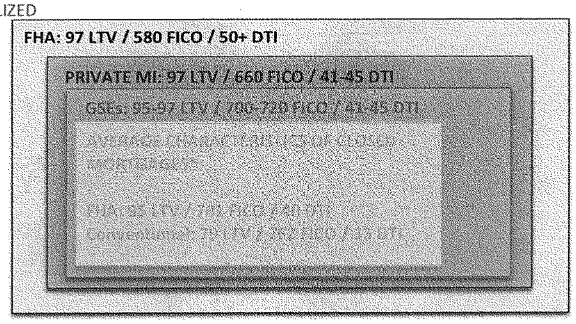
- The implementation of a 43 percent back-end debt-to-income (defined as total debt, including for example, housing debt, car loans and student loans) ratio (QM),
- Rebuttable presumption (QM),
- Full documentation, limits on exotic features (interest only, negative amortization, etc.) and Adjustable Rate Mortgage (ARM) rate resets (QM and QRM)
- Higher down payment requirement of 20 percent (QRM), and
- A high credit standard roughly equivalent to a 690 FICO (QRM).[1]

In addition to D-F, the new Basel III (B3) rules requiring banks to hold more capital will also impact credit availability, the cost of credit, and mortgage finance. U.S. regulators have chosen to augment – not merely adopt – the B3 capital rules with an additional risk-weighting scheme that will raise the amount of capital banks must have in order to hold mortgages in portfolio with down payments less than 20 percent. These rules are likely to have a significant impact on mortgages that do not meet standards for underwriting and ability to repay as defined by the regulators; as well as for most second liens. The regulations do not permit banks to use mortgage insurance (MI), a departure from current rules, to hedge the risks of low down payments, increasing their stringency.

Taken as a whole, QM, QRM, and B3 will limit the amount and variety of mortgages that banks will hold in portfolio. They will also cause banks to be cautious in how they originate loans for sale to the GSEs and FHA for fear of writing loans that will not be accepted and would then have to be held in portfolio. One way to think about the impact, especially the caution in originating loans that may end up in portfolio, is that the rules essentially make permanent current credit conditions in which originators have independently scaled back activity in response to the legal and reputational costs associated with GSE "put-backs" and the risk thereof (See Figure 1).

[1] FHFA: Mortgage Market Note 11-02, April 11, 2011

FIGURE 1. CURRENT TIGHTENING OF PURCHASE CREDIT BOX: ACCEPTABLE LOAN PROFILE VS. REALIZED



*Ellie Mae – September 2012

Together D-F and B3 will raise the cost of borrowing for millions of homebuyers, and tighten access to credit beyond pre-boom standards, a period of much more responsible lending than in the lead-up to the housing crisis. Banks will be forced to be more cautious in the types of loans they originate, even those sold to the GSEs and FHA. The tightening of credit would reduce access to affordable mortgages for many first-time homebuyers and trade-up buyers alike, reducing the volume of new buyers necessary to support trade-up buyers. The restriction in private lending will likely also drive consumers to government programs like the Federal Housing Authority (FHA) and the GSE's, which are exempt from the QRM requirements.[2]

These restrictions on private mortgage origination and housing market activity are a significant cost of the new regulatory regime; one that properly should inform the extent to which the new rules are sensible. To the extent that these regulations overreach, they violate the balance of benefits and costs that characterize efficient regulation, and will merit reform. Discussion of any reforms is beyond the scope of this paper. We turn now to documenting the plausible magnitude of these costs.

Estimating the Housing and Macroeconomic Impact of D-F and B3

The channels by which restricted mortgage credit would impact housing markets and the macroeconomy are straightforward. Tighter credit would reduce the number of new and existing home sales. In turn, residential construction would suffer and fewer dollars would be spent on the goods and services that would otherwise accompany home construction and purchases. In addition, housing inventories would either rise or decline at a slower rate, which would slow price growth. A decline in home prices would reduce housing wealth and cause a decline in personal consumption expenditures.

Quantifying these channels is another matter entirely. There is a wide array of estimates of the QRM's impact on mortgage rates, but less so for the QM or B3[3]. And conventional macroeconomic models do not have a channel for imposing an increased cost of credit from a regulatory source.

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[2] The FHA is exempted and the GSEs are exempted while in receivership.

[3] See MBA comment letters on QM and QRM: http://mba.informz.net/MBA/data/images/qmcommentletter070912.pdf and http://www.cognops.com/wp-content/uploads/2012/10/mba_basel_iii_comment_letter_final.pdf

We take another tack. To begin, note that the credit environment of 2009 through 2011 has the same characteristics as embodied in the proposed regulatory regime. Following the implosion of the subprime market and recession, banks independently raised credit standards to shore up their books, to comply with enhanced supervision, to provide for future product liquidity, and to prevent against potential repurchase requests or reputation risk. Full or near-full documentation is now the norm and access to exotic mortgage products is very limited. The average FICO score on FHA and conforming loans rose substantially. Down payment requirements outside of the FHA also rose, splitting the market and pushing borrowers with loan-to-value (LTV) greater than 80 to FHA. The average FICO score for *accepted* FHA purchase loans in September of 2012[4] was 701, well above the 660 mark that denotes a prime mortgage.[5] At the same time, the average characteristics for *rejected* conforming purchase loans were a FICO of 729, LTV of 81 percent and debt-to-income ratios (DTI) of 24 percent on the front-end and 43 percent on the back-end. Shown previously in Figure 1, the current tightened credit standards that have limited the number of potential borrowers and pushed market share towards FHA are similar to the same credit restrictions that will result from the proposed regulatory regime.

This tight credit regime is quite consistent with imposition of D-F and B3.[6] In particular, we observe:

- Stringent average origination characteristics (FICO, LTV, and DTI) well within the proposed requirements as a result of regulatory uncertainty and put-back and reputation risk[7], which are utilized as a proxy for tighter origination behavior under QM (rebuttable presumption) and B3 (capital weight risks enhancing potential put-backs);
- Tighter adherence to documentation;
- Low usage of exotic loans; and
- Shift of high LTV and high DTI lending to the FHA.

In short, we think of this period as a useful observation on the conditions "after" imposition of regulations.

As a proxy for market conditions "before" the regulations, we assume that mortgage originations in 2001 are close to historic norms, and not reflective of the loose credit underwriting common during the height of the housing boom[8].

To make the comparison, we constructed the distribution of mortgage production in 2001 and 2011 from the McDash database from Lender Processing Services (LPS). The distribution is based on FICO[9] scores measured at origination with exotic product features excluded.[10] Our goal is to construct a baseline 2011 distribution that would prevail in the absence of D-F and B3. The key assumption in doing so is that we assume that if

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[4] Ellie Mae. "Originations Insight Report." August 2012

[5] OCC Mortgage Market Metrics Report. First Quarter 2012

[6] The average *accepted* conforming loan for a purchase had a FICO of 763, LTV of 79%, and DTIs of 21% and 33%.

[7] Solomon, Deborah. "What Will It Take to Get Banks to Make More Loans?". Bloomberg News. Sep 11, 2012

[8] Demyanyk and Van Hemert (2008) demonstrated that there was a monotonic deterioration of sub-prime loan quality from 2001 to 2007 as well as increased average LTV, low doc share, and lower rate spread. An ideal base year would be much earlier (mid to late 1990s), but there is limited data available for an earlier base year.

[9] A distribution in two dimensions, LTV and back end DTI would be ideal. However, data on DTI is incomplete in most datasets and problems with collection of this statistic have been cited in the past (see Zandi and De Ritis: "Reworking Risk Retention"). Furthermore, one would expect a consumer to shop their mortgage to options that allow for higher DTI like FHA.

[10] For example, it excludes interest only mortgages, negative amortization mortgages, option ARMS, and ARMs with an initial rate resets less than 7 years.

credit were available today under normal, 2001 conditions, the volume of originations for FICOs greater than 690 would be the same. (Notice that a FICO of 690 is well above the 660 threshold for prime loans and is the figure estimated by the FHFA to coincide with the QRM credit requirement.)

Knowing this, and assuming the 2011 baseline distribution would mirror the 2001 distribution, permits us to estimate the total volume of originations that would have been originated in 2011 without D-F and B3. Not all mortgages are documented in the LPS data; we can use available information to impute the size and distribution of these "shadow" mortgages.[11] Because of employment issues, lower FICO scores, and down payment requirements not present in 2001, the resulting distribution likely overstates mortgage production in 2011. In order to be conservative, we assume that any loan with either a FICO or DTI in the LPS dataset could be fully documented, but for caution we assume 4.5 percent to 9.0 percent of the estimated 2011 "shadow" purchase production cannot be documented.[12 13]

The bottom line is the difference between the baseline 2011 estimate and the actual 2001 mortgage production. Our estimate is that tighter credit standards would lead to roughly 14 percent to 20 percent fewer loans.

This decline in purchase lending would reduce total home sales by 9 percent to 13 percent and a similar decline for existing home sales. However, cash purchases of existing sales increased in recent years and accounted for roughly 31 percent of existing purchases in 2011. This high share of cash purchases may be unsustainable, which would increase the impact of restricted credit on home sales. In this sense, ours is a conservative estimate of the impact.

Limited Housing Credit and the Economy

We translate our estimate of the regulation-induced mortgage reduction into impacts on the macroeconomy. The decline in existing home sales in turn reduces expenditures on goods and services related to the purchase of a home. Fewer existing home sales allow slack to remain in the supply of housing, weighing on home price appreciation and new construction activity. In addition, the wealth effect is muted by slower home price growth. Using this analytical framework, estimates for the impact of lower existing home purchases were produced using the Macroeconomic Advisors economic model.

The baseline scenario – one in the absence of D-F and B3 rules – is provided along with our estimated impact of D-F and the B3 rules.[14] The baseline takes into account that banks, on their own accord, have begun reacting to the potential rules, and as such these regulations have already had some effect. The impacts of tight lending in 2011 and combined effect of D-F and B3 are as follows.

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[11] The majority of 2011 loan production that is not documented can be imputed as long as a DTI or FICO score is present; those without either were dropped to make a more conservative estimate.

[12] 10 percent of these "shadow" loans with 620<FICO<680 would drop out due to employment issues; 20 percent of these "shadow" loans with FICO<620 would drop out due to employment issues; 33 percent of these "shadow" loans with FICO<620 would drop out due to the FHA's 10 percent down payment requirement for loans with FICO <580, new since 2001 (See Footnote 13)

[13] See Harriet Newberg, "Recent Trends and Their Implications for the Future." Federal Reserve Bank of Philadelphia. December 2011. Table 10 contains a distribution of FHA lending by FICO range in 2004 with shares below 580 and below 570 with LTV<90. We assume that slightly more loans with LTV<90 are bunched between 570 and 580 and that this is representative of the universe of mortgages with low FICO scores.

[14] In practice, banks on their own accord have begun reacting to the potential rules, and as such these regulations have already had some effect.

- A decline in home sales of 600,000
- Up to 1,010,000 fewer housing starts from 2013 to 2015, clipping 1.1 percentage points from GDP growth and resulting in 3.9 million fewer jobs over that time frame
- Though prices have risen in 2012 due to reduced inventories, long-term price growth could be stunted by the implementation of D-F and B3, lowering the potential housing wealth impact. 600,000 fewer home sales would translate into an equivalent amount added to inventory. The combined effect of fewer home sales and additional inventory would push the month's supply from the 6-month level observed in 2012 closer to a 9-month supply, which historically has been associated with moderate price declines. Though the price impact is difficult to assess, if the price delta (the difference between what the price growth would have been with and without credit restrictions) is 10 percent, then the reduced housing wealth accumulation would lower consumer spending by $80 billion to $130 billion or roughly an additional 0.3 percent off GDP growth per year and 200,000 fewer jobs.

This analysis is dependent on the size of the reduction in housing starts assumed. A sensitivity analysis was conducted that spans a range of changes in housing starts and their impact on the economy. The range of potential impacts from D-F and B3 is displayed below. In comparison to the baseline projections, new regulations would result in 260,000 to 1,010,000 fewer housing starts, 0.3 to 1.1 percentage points off of GDP growth, and 800,000 to 3.9 million fewer jobs from 2013 to 2015. Figures 2, 3, and 4 below show the differences in housing starts, GDP growth, and the employment level between the baseline estimate of 400,000 additional housing starts and the resulting impacts from the D-F and B3.

FIGURE 2. HOUSING START PROJECTIONS FROM BASELINE

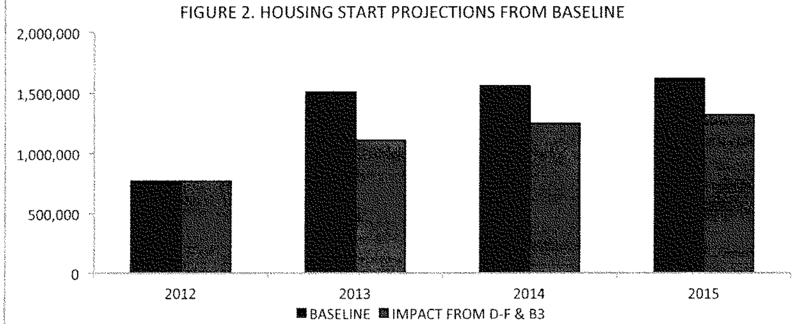


FIGURE 3. GDP GROWTH PROJECTIONS FROM BASELINE

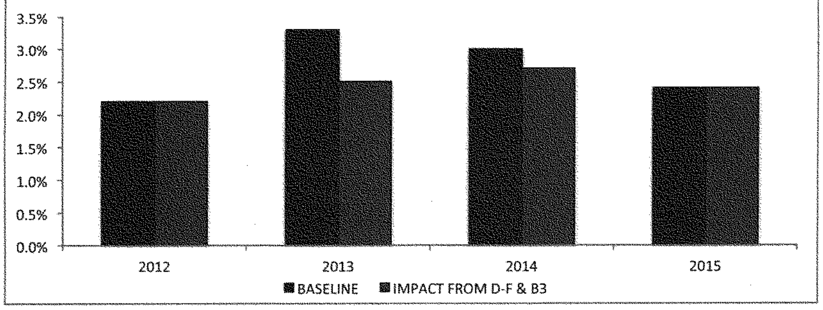
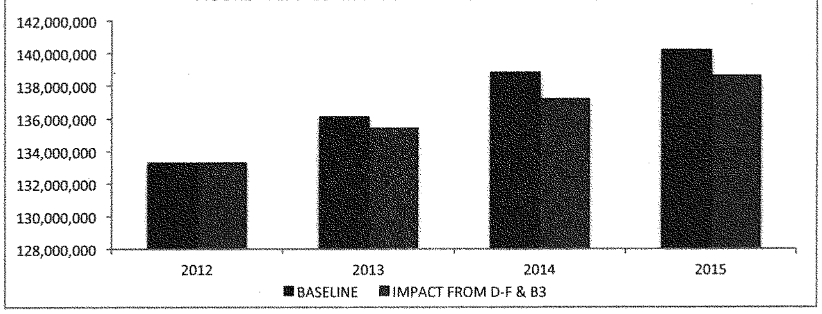


FIGURE 4. EMPLOYMENT PROJECTIONS FROM BASELINE



Over time, the economy would adjust to the regulatory shock, return to full employment, and there would no further drag on GDP growth. However, the economy would be at a lower level of GDP as the impact is "baked in."

Additional Impacts

Our approach has been to isolate and quantify the impacts of D-F and B3. However, in practice these impacts have already begun to affect housing markets as banks anticipate the new rules. And there are many impacts of this regulatory effort that are not captured here, but which merit consideration. In the past, more than 20 percent of small business owners have used equity in their homes to raise capital for their business or to use as "collateral to purchase business assets".[15] Small businesses are important for job creation, so slower price growth would make it more difficult for the economy and employment to expand.

[15] NFIB. "Small Business Credit in a Deep Recession." February 2010. P.18

Slower price growth implies slower growth of home equity. Under such conditions, mortgaged homeowners would be more vulnerable to foreclosure in the event of health issues, death of a family member, or unemployment.[16]

In a similar way, slower home equity appreciation would reduce trade-up buying, which would reduce spending on redecoration and the like. Slow price growth would also make it more difficult to refinance, especially given the higher requirements for refinances under the QRM.

Finally, American consumers have expressed a clear preference for the stability of the 30-year fixed rate mortgage. The premium capture reserve, a rule that would force mortgage bond securitizers to hold even more capital beyond proposed risk retention rules, would create a disincentive for banks to offer the 30-year fixed rate mortgage and a smaller role of the government in the secondary market would shrink support for it as well.

Summary and Conclusions

In January of 2013, the release of the final QM, QRM, and Basel III regulations is expected. These rules will dramatically reshape the primary and secondary mortgage market for the next generation. If done correctly, they could provide the safety and security for both consumers and investors necessary to sustain a housing recovery and beyond. But if these regulations are implemented in an overly strict fashion, they will lower the trajectory for homeownership and the economy for generations to come.

We have attempted to shed light on the magnitude of the impacts. We find using conservative economic assumptions that the bottom line effects of proposed Dodd-Frank and Basel III regulations may include up to 20 percent fewer loans, resulting in 600,000 fewer home sales. In turn, the resulting tightened lending and reduced sales are estimated to cost up to 1,010,000 housing starts, 3.9 million fewer jobs, and a loss of 1.1 percentage points from GDP growth over the next three years.

[16] Foote, Christopher, Kristopher Gerardi, and Paul Willen."Negative Equity and Foreclosure: Theory and Evidence," Journal of Urban Economics, 2008, 64 (2), 234-245.