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STATEMENT OF

MICHAEL H. KRIMMINGER
GENERAL COUNSEL
FEDERAL DEPOSIT INSURANCE CORPORATION

on

UNDERSTANDING THE IMPLICATIONS AND CONSEQUENCES OF THE PROPOSED RULE ON RISK RETENTION

SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES

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Chairman Garrett, Ranking Member Waters and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation on the proposed interagency rulemaking to implement the risk retention requirements of section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The FDIC and our colleagues at the other agencies recognize that the comments and feedback from Congress and the public are vital to helping us balance competing considerations and complete final rules that achieve the statutory requirements in the most efficient way possible.

The recent financial crisis exposed shortcomings in our regulatory framework for monitoring risk and supervising the financial system. Insufficient capital at many financial institutions, combined with misaligned incentives in securitization markets and the rise of a large unregulated shadow banking system, permitted excess and instability to build up in the U.S. financial system. These conditions led directly to the liquidity crisis of September 2008 that froze our financial system and contributed to the most severe economic downturn since the Great Depression. Today, levels of foreclosures remain high, the secondary mortgage markets remain dependent on government programs, and the private residential mortgage securitization markets remain largely frozen. Serious weaknesses identified with mortgage servicing and the foreclosure process have introduced further uncertainty into an already fragile market.

Background

The private securitization market, which created more than $1 trillion in mortgage credit annually in its peak years of 2005 and 2006, has virtually ceased to exist in the wake of the financial crisis. Issuance in 2009 and 2010 was just 5 percent of peak levels. There is no question that we must have an improved model for securitization based on sound underwriting and effective alignment of incentives that will support sustainable lending and a stable securitization market. Without this framework, we will repeat the same mistakes that resulted in disastrous consequences to our economy and caused the 5.3 million borrowers that entered the foreclosure process in 2009 and 2010 to be at risk of losing their homes.

Misaligned economic incentives within mortgage securitization transactions and the widespread use of such securitizations to fund residential lending combined to play a key role in driving the precipitous decline in the housing market and the financial crisis. Almost 90 percent of subprime and Alt-A originations in the peak years of 2005 and 2006 were privately securitized. During this period, the originators and securitizers seldom retained "skin in the game." These market participants received immediate profits with each deal while secure in the knowledge that they faced little or no risk of loss if the loans defaulted. As a result, securitizers had very little incentive to maintain adequate lending and servicing standards. The substantial and immediate profits available through securitization skewed the incentives toward increased volume, rather than well underwritten, sustainable lending. As underwriting standards continued to decline in order to facilitate an increased volume of loans for securitization transactions,

increased numbers of borrowers received loans that they simply could not repay. This "originate-to-distribute" model of mortgage finance led to increasing levels of unsound loans being originated and escalating housing prices that in turn fueled the housing bubble. When housing prices reached unsustainable levels and began to decline, the house of cards collapsed and revealed the inherent flaws in the incentives of the prior securitization model.

The mortgage servicing documentation problems that were uncovered last year are yet another example of the implications of lax underwriting standards and misaligned incentives in the mortgage origination, securitization and servicing industries. In particular, the traditional, fixed level of compensation for loan servicing proved wholly inadequate to implement appropriate policies and procedures to effectively deal with the volume of problem mortgage loans. Inadequate resources led mortgage servicers to cut corners in all aspects of mortgage servicing and documentation.

The mortgage underwriting and servicing practices that contributed to the crisis need to be significantly strengthened and the economic incentives of market participants must be realigned. Thus far, this "strengthening" has largely been accomplished through the heightened risk aversion of lenders, who have tightened underwriting standards, and through investors, who have largely shunned new private securitization issuances. Going forward, however, investors' level of risk aversion will inevitably decline in the pursuit of a higher rate of return, and there will be a need to ensure that lending standards do not revert to the risky practices that contributed to the last crisis.

Our testimony will highlight areas in the recent proposed joint Agency[1] rules implementing section 941 of the Dodd-Frank Act that are of particular importance in establishing risk retention requirements and in developing criteria for high quality mortgages not subject to the risk retention requirements.

Proposed Joint Agency Rules

Subtitle D of Title IX of the Dodd Frank Act seeks to improve the asset-backed securitization process by requiring risk retention, greater transparency, improved representations and warranties, and mandatory due diligence by issuers of the securities. The risk retention requirement of section 941 of the Dodd-Frank Act is but one part of the comprehensive framework created by Subtitle D of Title IX to address lapses in the securitization market. The disclosures mandated by sections 942 and 943 of the Dodd-Frank Act will serve to enhance the transparency of the securitization markets and will improve the quality of the assets included in securitization pools. These provisions will serve as checks and balances on asset origination practices and will enable investors to evaluate repurchase obligations, instead of being exposed to unquantifiable asset repurchase risks. Further, mandated due diligence review of assets underlying the securitization required by section 945 will go a long way toward ensuring the integrity of the asset pools that are being securitized. The proposed risk retention rules, therefore,

[1] The Agencies issuing the proposed rulemaking are the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Securities and Exchange Commission and, in the case of residential mortgage assets, the Federal Housing Finance Agency and U.S. Department of Housing and Urban Development.

should not be viewed in isolation; they should be considered an important part of a comprehensive regulatory regime designed to create increased accountability for originators and securitizers and increase the information available to investors in the securitization markets.

Section 941 mandates a joint interagency rulemaking to require securitizers to retain not less than 5 percent of the credit risk of any asset that is transferred, sold, or conveyed to a third party through the issuance of an asset-backed security and to prohibit the securitizer from directly or indirectly hedging or transferring the retained interest. Section 941 also directs the Agencies to provide an exemption from the 5 percent risk retention requirement for certain classes of assets that meet underwriting standards and product features prescribed by the Agencies.

The issues covered in section 941 of the Dodd-Frank Act are complex and have generated a robust debate, both among the Agencies tasked with the rulemaking as well as market participants, consumer groups and other interested parties. The Agencies differing responsibilities to regulate a diverse range of entities and markets positively contributed to our ability to analyze the issues and respond to the challenges posed by securitization markets in a comprehensive manner. The joint proposed rulemaking asks an extensive number of questions about these complex issues.

Our testimony addresses a few of the key issues incorporated into the proposed rules. It does not cover all of the complex issues included in the proposed rules, such as

the underwriting standards for the three other asset classes (qualifying commercial real estate, commercial and auto loans) for which the Agencies were directed to develop rules. These and other issues also are of vital importance to the reestablishment of a sustainable and vibrant securitization market that will support the credit needs of our complex economy. We certainly look forward to comments on all of these aspects of the proposed rules in order to ensure that the final rules achieve the goals set by the statute.

Five Percent Risk Retention

As required by section 941, the proposed joint Agency rules require securitizers of asset-backed securities to retain not less than 5 percent of the credit risk of the securitized assets in most transactions. The proposed rules ensure that securitizers retain "skin in the game" and align securitizer interests with those of the securitization investors. The proposed rules will encourage better underwriting by assuring that securitizers cannot escape the consequences of their own lending practices. Fundamentally, the requirements are about reforming the "originate-to-distribute" model for securitization, and realigning the interests in structured finance towards long-term, sustainable lending.

Securitizers are able to pick from a number of options to achieve this 5 percent risk exposure. These options reflect existing market structures and are designed to provide a large degree of flexibility to market participants in structuring transactions, while simultaneously ensuring that securitizers are not able to off-load all of the risk in a

transaction. These options work in tandem with the premium capture reserve account to provide a total level of risk retention that is appropriate for different types of assets and structures.

Premium Capture Reserve Account

The premium capture reserve account is designed to realign the incentives towards quality underwriting by eliminating the ability of a securitizer, or originator, to capture immediately the full amount of the profit from securitization. In fact, even though some risk retention was a common feature of securitizations in the past, the ability to capture a large profit or gain immediately upon the sale of the senior bonds meant that the retained risk had little influence on underwriting standards and asset quality and made risk retention meaningless. Securitizers' ability to capture the full amount of profit up front was a major contributor to the incentives that increased volume at the expense of quality lending under the "originate to distribute" model.

To prevent a securitizer from reducing or negating the effects of risk retention by monetizing excess spread, the proposed joint Agency rule requires the issuer to hold the upfront profits or premium on the sale of the asset-backed securities in a premium capture reserve account. Funds deposited into the account must be used to cover losses on the underlying assets before the losses are allocated to any other securitization interest. The premium capture reserve account requirement complements risk retention by ensuring that a securitizer's interests remain aligned with the underlying performance and quality

of assets, while providing the securitizer with an opportunity for profit contingent only upon the longer-term performance of the underlying assets. The securitizer will receive the profits over time if the loans perform or, depending on the structure, after the more senior tranches have been paid off.

Qualified Residential Mortgages

While Congress set a standard of 5 percent risk retention, it also directed the Agencies to create an exemption for certain high quality home mortgages (Qualified Residential Mortgages or QRMs) "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default." The proposed rules seek to implement this statutory direction by setting strong underwriting and product feature requirements based upon extensive data made available principally by the Board of Governors of the Federal Reserve System and the Federal Housing Finance Agency, as well as by sources of proprietary information. The standards for QRMs in the proposed rules are designed to define only a subset of the normal mortgage market that the historical data have demonstrated to have a "lower risk of default." Historical loan performance data indicates the volume of residential mortgage loans that potentially meet the proposed QRM underwriting criteria is approximately $2.1 trillion or about 20 percent of all residential mortgage loans in the U.S. Approximately $8.5 trillion would *not* have qualified for the QRM exemption. The size of the potential non-QRM market will ensure a vibrant and liquid market for non-QRM loans.

The proposed standards for QRM loans focus on the underwriting and servicing standards that the available data indicate reduce the risk of default. Those standards include verification and documentation of income, past borrower performance, a prudent debt-to-income ratio for monthly housing expenses and total debt obligations, elimination of payment shock features, a maximum loan-to-value (LTV) ratio, a minimum down payment requirement, and other quality underwriting standards.

The Agencies' analysis of the data show, historically, that loans with the high standards chosen for QRM loans had lower rates of default. In fact, many of the underwriting standards proposed for the QRM loans precisely address the layered risks that were often ignored during the housing boom that led to increasingly higher delinquencies as housing prices declined. For example, it has been demonstrated that the combination of a high debt-to-income ratio for housing expenses and high total debt obligations leads to an increased likelihood of default.

Similarly, the Agencies' analysis of historical loan data showed a significant relationship between higher loan-to-value ratios and increased risk of default. As a result, the proposed rules set the maximum LTV at 80 percent and the minimum down payment at 20 percent for purchase transactions.

The QRM exemption is meant to be just that – an exemption from the regular rules. Under the proposed rule, not all homebuyers would have to meet the higher QRM standards to qualify for a mortgage. On the contrary, we anticipate that loans meeting the

QRM exemption will be a small slice of the market, with greater flexibility provided for loans securitized with risk retention or held in portfolio. The more stringent standards in the QRM exemption, such as debt-to-income ratios and LTV requirements, have raised concerns about continued access to affordable mortgage credit for low and moderate income borrowers. The FDIC shares these concerns and seeks to ensure that low- and moderate-income borrowers continue to have access to affordable mortgage credit. It is for this reason that the Agencies have sought to ensure that the non-QRM segment of the market will be cost effective for low- and moderate-income borrowers and be large enough to ensure a vibrant and liquid secondary market. We are seeking comment on the impact of the QRM standards on these borrowers as we work towards the final rules. In particular, we welcome comment on how and whether we can assure the unique needs of low- to moderate-income or first-time homebuyers can be met through other means such as Federal Housing Administration programs and down payment assistance programs.

The FDIC disagrees with those who suggest a borrower's interest rate will increase substantially when the cost of risk retention is passed through to the borrower. The FDIC's analysis indicates that the 5 percent risk retention requirement should result in only a nominal additional cost to non-QRM borrowers. The idea of risk retention in the securitization market is not a new concept. Our review of private mortgage securitization deals done in the early years of the last decade shows that risk retention of 3 to 5 percent or more was the norm. Risk retention will raise the cost of funding mortgage securitization only to the extent that the requirement exceeds what investors would demand on their own. To illustrate the potential impact of risk retention on a

borrower's costs, if the final rules were to require 5 percent risk retention where the market would have otherwise only demanded 3 percent, our analysis shows the cost of funding that mortgage pool would rise by only 10 basis points or 0.10 percent.

Mortgage Servicing Standards

Also included in the QRM standards are loan servicing requirements. Continued turmoil in the housing market caused by inadequate and poor quality servicing underscores the need to make sure that future securitization agreements provide appropriate resources and incentives to mitigate losses when loans become distressed. Servicing standards must also provide for a proper alignment of servicing incentives with the interests of investors and address conflicts of interest. The servicing standards included as part of the QRM requirements address many of the most significant servicing issues. For example, the servicing standards require that there be financial incentives for servicers to consider options other than foreclosure when those options will maximize value for investors.

The proposed standards also require servicers to act without regard to the interests of any particular tranche of investors; and to workout and disclose to investors in advance how second liens will be dealt with if the first lien needs to be restructured. We welcome comments on whether the servicing standards should be strengthened and whether the standards should apply to all private securitizations, not just QRM securitizations.

Conclusion

The Dodd-Frank Act and the proposed joint Agency rulemaking address one of the key drivers of the housing crisis: misaligned economic incentives in the private securitization market. In formulating the proposed rules, the Agencies sought to balance requiring the securitizer to keep "skin in the game" with a desire to minimize disruptions to existing market structures. We look forward to hearing from all stakeholders on the issues raised in the rulemaking and finalizing regulations that will restore investor confidence and the soundness of the securitization market. The comment period ends on June 10, 2011.