Testimony of Mark A. Calabria, Ph.D.

Director, Financial Regulation Studies, Cato Institute

Before the

Subcommittee on Capital Markets & Government Sponsored Enterprises

House Committee on Financial Services

On "H.R. _____, the Private Mortgage Market Investment Act, Part 2"

December 7, 2011

Mark A. Calabria, Ph.D. is Director of Financial Regulation Studies at the Cato Institute. Before joining Cato in 2009, he spent seven years as a member of the senior professional staff of the U.S. Senate Committee on Banking, Housing and Urban Affairs. In that position, he handled issues related to housing, mortgage finance, economics, banking and insurance. Prior to his service on Capitol Hill, Calabria served as Deputy Assistant Secretary for Regulatory Affairs at the U.S. Department of Housing and Urban Development, and also held a variety of positions at Harvard University's Joint Center for Housing Studies, the National Association of Home Builders and the National Association of Realtors. He has also been a Research Associate with the U.S. Census Bureau's Center for Economic Studies. He holds a doctorate in economics from George Mason University.
http://www.cato.org/people/mark-calabria

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Chairman Garrett, Ranking Member Waters, and distinguished members of the Subcommittee, I thank you for the invitation to appear at today's important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a nonprofit, non-partisan public policy research institute located here in Washington, DC. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official positions of the Cato Institute. In addition, outside of my interest as a citizen, homeowner and taxpayer, I have no direct financial interest in the subject matter before the Committee today, nor do I represent any entities that do.

Need for Reform

It should be beyond dispute that our Nation's system of residential mortgage finance is badly broken. A few tweaks here and there will not suffice. Major structural reform is needed. Never again should the taxpayer be forced to pay tens of billions to bail-out the mortgage finance industry. It is well worth remembering that the most recent bailout is not the first. The Savings and Loan crisis of the 1980s was essentially a taxpayer financed bail-out of the mortgage-finance and housing sectors. We cannot leave the taxpayer holding the bag the next time the housing market goes boom and bust, which it will. We have not ended either the business cycle or the related housing cycle. If anything our current system has made those booms and busts worse.

Rebuilding the Private Label Mortgage-Backed Securities Market

I commend the Chairman for his efforts constructing the "Private Mortgage Market Investment Act." While I believe we cannot completely replace our current system solely with private label securities, for instance returning to a structure based more on deposit-funded portfolio lending should be key to any reform, the draft legislation before the Committee represents an important step in the process. And while I would prefer to see quicker efforts to shrink and ultimately eliminate Fannie Mae and Freddie Mac, fostering alternatives in the interim is far better than doing nothing at all. We should bear in mind that as long as the heavy hand of subsidized government is tilting the scales, any private market solution will be hobbled.

My testimony will focus on the discussion draft before the Subcommittee. None of my comments should be construed as supporting any taxpayer guarantee of the mortgage market. Our ultimate objective should be a market where those taking risks bear both the up-side and down-side of those risks. Neither lenders nor borrowers should be able to keep gains while sticking the taxpayer with losses. If lenders or borrowers wish to have "insurance" against extreme market events, then they should purchase such insurance on the open market like any other good. In addition, any efforts to "standardize" the mortgage market should be temporary.

Ultimately the free and voluntary choices of market participants, and not the coercive force of government, should determine the structure of our mortgage market.

As the discussion draft was only recently circulated my comments should be viewed as preliminary and intended more to generate discussion and analysis than to settle any outstanding questions.

Title I – Standardization and Uniformity

Before making specific comments as to the legislative language in the draft, I believe the Subcommittee should bear in mind that it is possible to have too much standardization and uniformity. In fact one of the central flaws of our current system is the dominance of a particular model – government sponsored enterprise securitization. Dodd-Frank, particularly the Qualified Residential Mortgage construct, falls into this same mode of limiting consumer choice and innovation. One of the objectives of our federal mortgage policies should be to have a wide variety of options available to borrowers without unduly advantaging any particular product. No product choice should be either favored or disfavored by Washington. Of course the risks inherent in any particular mortgage product should be borne by the contracting parties and not the taxpayer.

The approach of Title I is that of standardizing mortgage pools by risk and then allowing those standardized pools to have an exemption from the registration requirements under the 1933 Securities Act. I believe this is a reasonable interim approach to moving towards a more private mortgage market. This is particularly important given the exemption of Fannie Mae and Freddie Mac debt/MBS from the registration requirements of the 1933 Act.

While I do question the expertise of the Federal Housing Finance Agency (FHFA) in the area of securities disclosure, I would ultimately move the responsibilities under Title I to the Securities and Exchange Commission, I again believe the structure of Title I and the involvement of FHFA is a reasonable interim step. Perhaps to insure that this is an interim step, the Subcommittee should consider including a reasonable sunset provision for FHFA authority in Title I. Something like five or six years should suffice. None of this should be taken to question the current performance of FHFA. Acting Director DeMarco has done an outstanding job given the complexities and pressures he has faced.

If Congress were to choose to either now or in the future move the authorities under Title I to the SEC, then such authorities should be broadened to include all asset-backed securities (ABS) and not simply mortgage-backed securities. One of the problems of the approach in the discussion draft, and likely an unavoidable one presently, is the continued "special" treatment of mortgages as an asset class. Ultimately the MBS market should look a lot more like the rest of ABS market. I will remind the Subcommittee that although auto loans and credit cards, for instance, both have default rates that rival mortgages, neither of these loan types, both of which are heavily securitized, were behind the financial crisis.

I have some concerns as to the competitive effects of Section 101(f) which directs FHFA to set standards for "qualified sponsors" of mortgage securitization. In addition to questioning FHFA's ability to gauge the quality of different sponsors, the most likely impact of 101(f) would be to reduce the number of sponsors with little overall impact on mortgage quality. As long as the identity of the sponsor is attached to the pool I believe that should be sufficient for market participants to distinguish, and price, across sponsors. I would suggest Section 101(f) be deleted from the draft. I make this suggestion with full appreciation of the provisions of Section

101(f)(3) on review and revocation of qualified status, which are in part indeed to reduce the extent to which 101(f) would act as a barrier to entry.

One of the more important portions of Title I is the repeal of the credit risk retention provisions of Dodd-Frank, contained in Section 102 of the discussion draft. I believe this is one of the more crucial provisions of the draft and strongly encourage its inclusion. Like all too many provisions of Dodd-Frank the risk retention requirements were based upon a false premise, that various market participants did not retain sufficient risk. The truth is much different. For instance the bulk of losses to Fannie Mae and Freddie Mac are from their credit guarantees of their MBS. If Fannie Mae and Freddie Mac had not retained that credit risk, and it instead flowed to the holder of the MBS, the taxpayer, and the economy, would be far better off today. The same holds with the various off-balance sheet entities used by the largest commercial and investment banks. The primary problem with these special investment vehicles was that the sponsoring bank ***did*** retain the risk, rather than truly transferring it. To summarize, one of the problems of our existing securitization model is that too often it allows for securitization without the actual transfer of risk. The appearance of securitization without the substance. Risk becomes far harder to manage in our financial system when it is pieced out to various parties rather than held by a single responsible party. If the Dodd-Frank risk retention provisions are kept, we will end up creating a “tragedy of the commons” in the context of credit risk.

Sections 104, 105, 106, 107 and 108 appear to be reasonable reproductions of securities law provisions that would be in place had Title I been placed under the authority of the SEC rather than FHFA. Along with the remainder of Title I, I would suggest these provisions have a sunset at which time Congress can consider whether such authorities should transfer to the SEC.

Title II – Transparency

While disclosure if often a good thing, it is possible to have too much of a good thing. In order to minimize disruptions to the mortgage market and to allow some room for experimentation, I suggest that all the provisions of Title II be limited to exempted securities as defined under Section 101(b)(4) of the discussion draft. If instead the exemption for qualified securities in Section 201(c) is retained, then I would suggest deleting Section 201. What information is made available to market participants for "non-qualified" securities should be driven by market conventions and not by statute.

Title III – Ensuring the Rule of Law

Regarding Section 301, it is not clear from the draft whether these provisions would apply to 1) all existing mortgages, 2) any new mortgage, or 3) mortgages in exempted securities as defined in Section 101(b)(4) of the discussion draft. The language suggests to me that these provisions would cover all existing and future residential mortgages. While the presence of a second lien is undoubtedly a risk factor, Sections 301(a) and 301(b) would re-write existing contracts, something which I believe is always and everywhere harmful and destructive to trust in our markets. It should not matter whether such a "re-writing" benefits/harms the borrower or the lender. I do not see the role of Congress as either remedying flaws in existing contracts, which should be left to the Courts, or simply changing the terms of an agreed-upon contract to benefit one party over another. Section 301(a) reads as little more than a forced transfer from borrowers to servicers. Accordingly, I urge the Subcommittee to **delete** Sections 301(a) and 301(b) or to at least limit its application to future mortgages covered in Section 101(b)(4).

Again recognizing that the securing of a junior lien will generally increase the default risk of a senior lien, how that risk is handled should be left to negotiation by the contracting parties. Current law (I believe it is within the Garn-St.Germain Depository Institutions Act of 1982), which prohibits the exercise of due-on-sale clauses in residential mortgages, should be repealed so that borrowers and lenders are free to address this issue without having a solution forced upon them.

To the extent that Section 301(c) prohibiting forced principal reductions is intended to respect existing contracts and limit the ability of regulators to coerce modifications, I believe that section should remain. Language could be added allowing principal writedowns where both the lender and the borrower agree and there is no involvement of the regulators. It is vital to the integrity of our regulatory system that our financial regulators behave in a manner that is neutral and arms-length. It should not the role of either Congress or our regulators to pick sides in private disputes.

Regarding Section 302, there have clearly been substantial conflicts of interests when servicers of a senior lien themselves are holders of a junior lien, however a blanket prohibition on future junior interests by mortgage servicers I believe is much too broad. There may well be situations where a junior interest, held by the servicer, is beneficial to the junior and senior lien-holders, as well as the borrower. At a minimum Section 302 should be limited to mortgages covered by Section 101(b)(4).

Section 303 is a reasonable approach to both protecting the consumer and providing a degree of legal certainty to originators. Section 303 should be retained largely as is. Ultimately I suggest the repeal of the entire Qualified Mortgage construct of Dodd-Frank. A re-working of the Truth-In-Lending Law, as badly needed as that is, however likely remains beyond the scope of the discussion draft.

An exception I would make to re-visiting TILA-HOEPA at a later date is the Federal Reserve's 2008 changes to HOEPA. Besides having little, if any basis, in statute (I recognize that has rarely stopped the Federal Reserve), the 2008 definitions of "higher cost" mortgage mean with today's interest rates any mortgage over 5.5%, quite low by historical standards, is considered higher costs. Given both the reputational and legal risks that come with higher costs mortgages, I believe the 2008 HOEPA changes have contributed to a drastic reduction in mortgage availability to higher risk borrowers. In 2005, 22 percent of the market was "higher-cost" according to HMDA data. By 2010 that share had fallen to 2.4 percent. Yes the housing bubble and credit crisis would have shrunk that market, but by almost 90 percent? And yes, many of those loans we do not want to come back, but many we do. At a minimum I would urge Congress to investigate the effect of the 2008 HOEPA changes on mortgage availability. A preferred approach would be to repeal those changes.

Role of the Rating Agencies - Repeal Dodd-Frank Section 939G

As much as I wish to see our capital markets less reliant on the credit rating agencies, it is difficult for me to envision in the current environment a vibrant private label MBS market without the use of rating agencies. As the Subcommittee is well aware Dodd-Frank's Section 939G has already had a tremendous negative impact on our capital markets, so much so that the SEC has effectively voided the provision. This Section, 939G, repeals SEC rule 436(g), which had exempted NRSROs from being deemed part of a security's registration statement. Rule 436(g) had protected NRSROs from liability under Section 11 of the 1933 Securities Act. This protection actually increased the flow and quality of information received by investors by encouraging the use of ratings in offering statements. Dodd-Frank's repeal of Rule 436(g) effectively shut down the new offerings market for asset-backed securities and corporate debt. It was only the issuance of a "no-action" letter from the SEC to Ford Motor Credit Company that allowed this market to function. However this no-action letter is temporary in effect leaving considerable uncertainty as to how our debt markets will function in the absence of Rule 436(g), at least until such time the markets evolve beyond the regular use of credit ratings. In order to encourage a vibrant private label MBS market, Congress should consider not only repeal of Section 939G but also placing the original exemptions contained in rule 436(g) into statute. While of lesser importance the Committee should also consider repeal of Dodd-Frank's Section 939B, the ban of the rating agency exemption from Regulation FD, covering "fair disclosure".

Conclusions

Again I commend the Chairman for his efforts and thank all members of the Subcommittee for their attention and consideration of my remarks. Quite frankly there should be no higher priority for this Subcommittee than the reform of our broken mortgage finance system. Continued delay adds to market uncertainty and hobbles the development of private market solutions. Delay also adds to the increasing taxpayer cost of bailing out our mortgage finance system. Whether in concern with other needed reforms, or alone, the discussion draft circulated by the Chair merits consideration. Thank you and I look forward to your comments and questions.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

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

1. Name:	2. Organization or organizations you are representing:
Mark A. Calabria	Cato Institute

3. Business Address and telephone number:

[redacted]

4. Have <u>you</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the <u>organizations you are representing</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☑ No	☐ Yes ☑ No

6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

Please attach a copy of this form to your written testimony.