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**Written Testimony of**

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Before the  
Senate Committee on Banking, Housing, and Urban Affairs

“Housing Finance Reform: Fundamentals of a Functioning Private Label Mortgage Backed Securities Market”

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## Witness Background Statement

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

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

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

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

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

## EXECUTIVE SUMMARY

1. PLS can only provide the financing for at most an eighth of the US housing market's peak annual financing needs. There is a role for PLS within the US housing finance system, but it is not realistic to expect PLS to provide a significant share of the housing finance system because there is insufficient capital markets demand for credit risk on US mortgages. At best, PLS will be able to support no more than \$500 billion of annual housing finance; the US housing finance market needs anywhere between \$1.5 trillion and \$4 trillion in annual financing, depending on interest rate conditions.
2. PLS is a "lemons" market in which investors cannot adequately gauge the quality of the underlying mortgages. The institutional structure of the PLS market frustrates investors' ability to make sure that securitized mortgages conform to the represented underwriting quality. Standard market discipline mechanisms such as specialized subordinated debt investors and reputational sanctions did not work in the PLS market, and it is unlikely that investors will rapidly return to this market.
3. The "Resurrected" PLS market consists of a very small number of deals involving ultra-prime mortgages. PLS has provided financing for only around 17,000 mortgages since 2008—fewer mortgages than originated in the District of Columbia alone last year. The mortgages financed through PLS averaged 65% LTV on properties valued at \$1.26 million, and the average borrower FICO score was 723.
4. The PLS market will not produce widely available, affordable 30-year fixed rate mortgages or provide pre-closing rate-locks. Private mortgage markets have never produced widely available long-term, fixed-rate mortgages or pre-closing rate locks anywhere in the developed world. To the extent that 30-year fixed rate mortgages are available in the private-label jumbo mortgage market it is not on the same terms as in the Agency market. Similarly pre-closing rate-locks are available on jumbo mortgages only because the jumbo market can hedge the risk in the Agency MBS forward contract market.
5. A PLS-based housing finance market poses serious systemic risk. PLS will result in geographic price discrimination as investors attempt to price credit risk. Geographic price discrimination can result in self-fulfilling predictions of housing price bubbles, and the flightiness of capital from PLS markets means that capital will not be available precisely at the times it is most needed.
6. There are several steps that can be taken to improve the PLS market, but PLS will never be able to support more than a small fraction of the US housing market. Investor trust in the PLS market can be improved through reforms regarding securitization contract standardization, the duties and compensation of trustees and servicers, representations and warranties, ratings agencies, and the diligence process.

An appendix contains some suggested improvements to S.1217, the "Housing Finance Reform and Taxpayer Protection Act of 2013" or "Corker-Warner" bill.

Mr. Chairman Johnson, Ranking Member Crapo, Members of the Committee:

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

My written testimony today goes into depth regarding the limitations of PLS to provide the financing for American’s homes. There is a place for PLS within the US housing finance system, but the bottom line of my testimony is that it is unrealistic to expect PLS to ever provide more than a small fraction of the capital necessary to finance the US housing finance system. There are reforms that can and should be done to improve the PLS market, but even with these improvements, PLS will remain incapable of providing more than about an eighth of America’s housing finance needs. It is not realistic to rely on the PLS market to create a stable housing finance system that serves the needs of all Americans.

Instead, a reform program along the lines of that proposed by S.1217, the “Housing Finance and Taxpayer Protection Act of 2013” or “Corker-Warner bill”, that features private first-loss capital backstopped by an explicit, and priced, federal guarantee, should be the basic model for rebuilding the housing finance system. There are important technical challenges and trade-offs in the details of such a reform program, and I suggest some possible improvements to S.1217 in an appendix, but the basic point should not be lost: PLS cannot be the foundation of the US housing finance system.

## **I. PLS OVERVIEW**

### ***A. Interest Risk Versus Credit Risk Investors***

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

The mortgage securitization market can be roughly divided into two types of securitizations based on their allocation of interest rate and credit risk: GSE and Ginnie Mae securities (“Agency MBS”) and private-label mortgage-backed securities (“PLS”).

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

In contrast, investors in PLS assume both interest rate risk *and* credit risk. Nonetheless, while in the past PLS investors formally assumed credit risk, few thought that they were

assuming more than *de minimis* credit risk. Typically, both credit and interest rate risk are not spread evenly among investors in PLS, but are instead allocated in a senior-subordinate tranching structure, with senior tranches assuming less risk and therefore receiving lower coupons than the riskier junior tranches. The overwhelming majority of PLS were rated AAA at issuance. In most PLS deals over 90% of the securities were initially rated AAA, with another perhaps 5% receiving lower investment grade ratings, and no more than 5% of the securities receiving non-investment grade ratings or not receiving a rating.

Investors who relied on these ratings understood the credit risk on these PLS to be negligible because of the quality of the underlying mortgages and various credit enhancements to the PLS, such as the senior-subordinate credit tranching, overcollateralization, excess spread accounts, and various types of insurance.

Indeed, the overwhelming majority of investors in the U.S. secondary mortgage market are not credit risk investors. Investors in Agency MBS are not credit risk investors, and most investors in PLS did not perceive themselves as assuming credit risk. Instead, most investors in the U.S. mortgage market are interest rate risk investors; PLS were an attractive asset class during the run up to the financial crisis because they were AAA-rated, yet had slightly higher yields than Treasuries, and were far more readily available than AAA-rated corporate securities. Thus, as Goldman Sachs CEO Lloyd Blankfein has noted, “In January 2008, there were 12 triple A-rated companies in the world. At the same time, there were 64,000 structured finance instruments . . . rated triple A.”<sup>1</sup> Thus, there is approximately \$6 trillion in interest-rate-risk-only investment in the US mortgage market.

Interest rate risk investors are very different types of investors than credit risk investors. Investing in credit risk successfully requires a different kind of diligence and expertise than interest rate risk investment. A large portion of the investment in U.S. mortgages is from foreign investors.<sup>2</sup> Middle Eastern sovereign wealth funds and Norwegian municipal pension plans, for example, are unlikely to seek to assume credit risk on mortgages in a consumer credit market they do not know intimately. But interest rate risk is something that foreign investors are far better positioned to assume because it is highly correlated with expectations about U.S. Federal Reserve discount rates. Indeed, it is hard to conceive how a foreign pension plan or even say a Wisconsin school teachers’ retirement fund could undertake meaningful diligence of mortgage underwriting practices.

### ***B. The Rise and Fall of the PLS Market***

PLS have existed since 1977, but were a small part of the housing finance market for many years. The PLS market began to take off in the mid-1990s following the S&L crisis as the risks of balance-sheet lending were better understood. By the mid 1990s, PLS were financing roughly twenty percent of the US housing finance system by dollar amount. At this point PLS was being used primarily to finance prime “jumbo” mortgages that were too large to meet the GSEs’ and FHA’s conforming loan limits, but also some subprime loans that failed to meet the GSEs’ credit quality requirements.

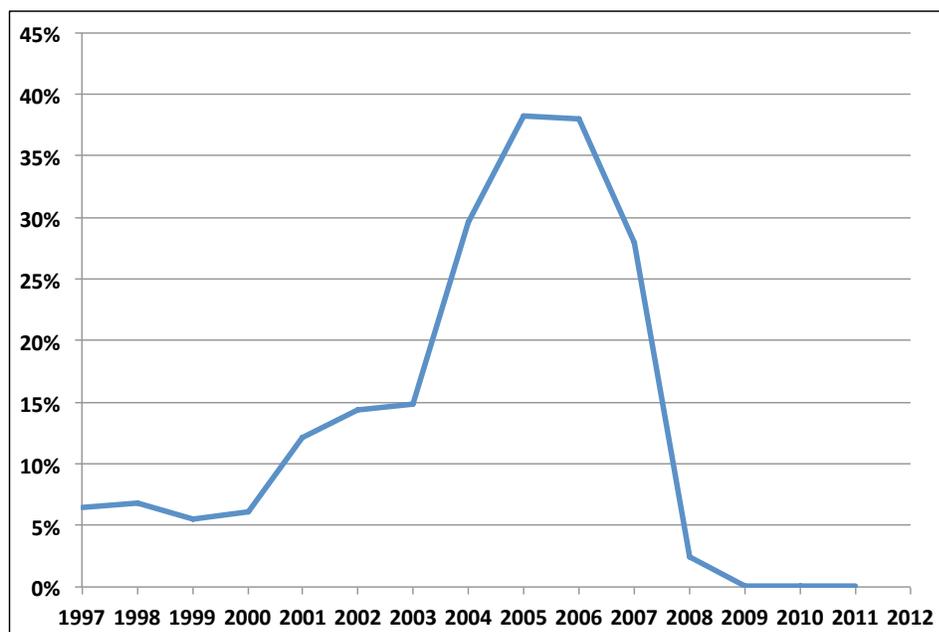
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<sup>1</sup> See Lloyd Blankfein, *Do Not Destroy the Essential Catalyst of Risk*, FIN. TIMES, Feb. 8, 2009, at 7.

<sup>2</sup> Ben S. Bernanke et al., *International Capital Flows and Returns to Safe Assets in the United States, 2003-2007*, Board of Governors of the Federal Reserve System International Finance Discussion Papers Number 1014, February 2011.

Starting in 2001, the share of subprime within the PLS market began to grow, becoming a majority of PLS by 2004,<sup>3</sup> when the PLS market took off as it provided the kerosene that fueled the housing bubble.<sup>4</sup> As Figure 1, below, shows, at its peak in 2005-2006, the PLS market provided the financing for 38% of mortgage lending (by dollar amount).<sup>5</sup> By 2008, however the PLS market had retreated to virtual non-existence.

**Figure 1. PLS Share of Mortgage Originations Finance by Dollar Amount<sup>6</sup>**



### ***C. The PLS “Resurrection”: Financing a Handful of \$1.26 Million Homes***

The PLS market has made a very modest recovery since 2008. As of September 26, 2013, there have been only 33 post-crisis PLS deals, accounting for a mere \$15.3 billion in housing finance.<sup>7</sup> These 33 deals provided financing for only 16,778 mortgages.<sup>8</sup> By comparison, there were over 8.6 million mortgages financed nationwide in 2012 alone.<sup>9</sup> In other words, PLS is financing far less than 1% of the US mortgage market.

<sup>3</sup> Inside Mortgage Finance, Mortgage Market Statistical Annual.

<sup>4</sup> Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1252-58 (2012); Adam J. Levitin & Susan M. Wachter, *Why Housing?* 23 HOUSING POL’Y DEBATE, 5 (2013).

<sup>5</sup> Inside Mortgage Finance, Mortgage Market Statistical Annual. PLS accounted for 56% of securitization at peak in 2006, but securitization volumes were only two-thirds of total mortgage origination volumes in 2005-2006.

<sup>6</sup> Inside Mortgage Finance, Mortgage Market Statistical Annual. The chart graphs the quotient of PLS issuance (excluding re-REMICs) over mortgage origination volume.

<sup>7</sup> Kroll Bond Rating Agency, RMBS: Transaction Comparison Report (9-19-13).

<sup>8</sup> *Id.*

<sup>9</sup> HMDA

The average home financed with these PLS mortgages was worth \$1.26 million or nearly 5 times the median price of a new home sale in August 2013.<sup>10</sup> The average mortgage size in these deals was nearly \$825,000,<sup>11</sup> over four times the national average.<sup>12</sup> These deals were backed by ultra-prime collateral: the average loan-to-value (LTV) ratio on these deals was 65%, and only 0.5% of the mortgages had an LTV of above 80%.<sup>13</sup> In other words, these were very high down-payment mortgages—typically 35% down.

Borrowers had pristine credit and clear ability to repay: borrower front-end debt-to-income (DTI) ratios averaged 30%; the average borrower's FICO (credit) score was 723 out of 850, a prime credit score; and all the mortgages were fully documented.<sup>14</sup>

Since 2008, then, the PLS market has provided financing to an exceedingly small number of super-low risk mortgages on extremely high value homes. This generates little confidence that the PLS market can be successfully expanded in the foreseeable future to support even 1% of the US housing finance market. Even if PLS were to return to its pre-bubble levels, it could not finance more than an eighth of peak US housing finance market capital needs.

## **II. A LEMONS MARKET: THE INSTITUTIONAL MECHANICS OF WHY THE PLS MARKET COLLAPSED**

To understand why the PLS market collapsed, it is necessary to understand how the institutional and contractual structure of PLS facilitated poor mortgage underwriting and misrepresentation of loan quality to investors, if not outright fraud, resulting in credit losses even for investors who thought they had not assumed any real credit risk. The result has been a complete loss of trust between buy-side investors and the sell-side financial institutions in PLS. Restoring the investor trust necessary to revive the PLS market will, at the very least, require regulatory intervention to mandate standard minimum investor protections.

### ***A. The Basic PLS Transaction***

The basic, stripped-down PLS transaction involves a financial institution (the “sponsor”) assembling a pool of mortgage loans that it either made itself or purchased. The pool of loans is transferred to a special purpose subsidiary of the sponsor (the “depositor”), and then the depositor transfers the loans to a trust that is legally independent from the sponsor and depositor. Legal title to the loans is then held by a trustee, while the trust engages an agent called a servicer to manage the loans. The trust pays the depositor for the loans by issuing securities, which the depositor then transfers to its securities affiliate for sale to investors following rating by credit rating agencies. Those securities are the private-label mortgage-backed securities (“PLS”).

The various rights and obligations of sponsors, depositors, servicers, trustees, and investors are set forth in what is typically a single transactional document, known as a pooling and servicing agreement (“PSA”). Some securitizations, however, split the transaction into

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<sup>10</sup> <http://www.bloomberg.com/news/2013-08-27/home-prices-in-20-u-s-cities-increased-at-slower-pace-in-june.html>.

<sup>11</sup> Kroll Bond Rating Agency, RMBS: Transaction Comparison Report (9-19-13).

<sup>12</sup> [http://www.fhfa.gov/webfiles/15882/avg\\_loan\\_size\\_2010Q2.csv](http://www.fhfa.gov/webfiles/15882/avg_loan_size_2010Q2.csv) (average loan sizes for GSE loans—most of the market).

<sup>13</sup> Kroll Bond Rating Agency, RMBS: Transaction Comparison Report (9-19-13).

<sup>14</sup> *Id.*

multiple documents, which might not be simultaneously executed. While the basic contours of PSAs tend to be similar, there is actually substantial variation among PSAs, including in: representations and warranties, putback requirements, servicing requirements and limitations, and investor collective action thresholds. This variation can exist even with a single “shelf” from the same sponsor.

The loans are transferred from sponsor to depositor and from depositor to trust with a set of representations and warranties about the quality and characteristics of the loans. The remedy for a representation or warranty violation is specified in PSAs as a “put back”—the return of the non-conforming mortgage to the depositor in exchange for either a conforming loan or the principal and accrued interest outstanding on the loan. The loans are otherwise transferred without recourse.

### ***B. Servicers***

The actual management of the mortgage loans for the trust is handled by an entity called a “servicer.” The servicer is responsible for collecting payments on loans, managing defaulted mortgage loans and real estate owned, and enforcing the representations and warranties made about the loans by the sponsor and depositor to the trust. Servicers are often (although not always) affiliates of the sponsor/depositor. This means that servicers are tasked with enforcing representations and warranty violations by their affiliates through putbacks.

Servicers are compensated with a percentage of the outstanding principal balance on each loan, the “float” on the funds they collect before remitting them to the trust, and any other fees they are able to collect from borrowers (such as late fees or modification fees).<sup>15</sup> These fees get paid off the top of collections, before any funds are paid to the PLS investors. Because servicers are paid off the top of collections, they are not incentivized to maximize recoveries for the trust. Thus, servicers might prefer to pursue a foreclosure instead of a loan modification if the foreclosure results in immediate cashflows sufficient to cover its compensation, despite a modification being better for PLS investors overall. Similarly, a servicer has little incentive to ensure that a foreclosure sale brings in a price higher than necessary to cover its own costs. While servicing is unlikely to change the likelihood of default in most cases, it has a major impact on loss given default.<sup>16</sup>

Servicers are also charged with guaranteeing a certain level of liquidity to the trust by “advancing” payments on delinquent mortgages to the trust to the extent that recovery of the advances is reasonably foreseeable. These advances are reimbursable from other collections, but without interest. The lack of interest and the liquidity strain of advances on servicers strongly disincentivizes them from making advances, despite a contractual obligation to do so.

Servicers may also have conflicts of interest with the trust because they may themselves (or through affiliates) hold junior mortgages on the properties on which the trust holds the senior mortgage. Thus, the servicer is both an agent of the trust and a competing creditor to the trust.

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<sup>15</sup> For a fuller description of servicer compensation and incentives, see Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1 (2011).

<sup>16</sup> Samuel Krueger, *The Effect of Mortgage Securitization on Foreclosure and Modification*, working paper, June 2013, at [http://scholar.harvard.edu/files/skrueger/files/securitization\\_and\\_foreclosure.pdf](http://scholar.harvard.edu/files/skrueger/files/securitization_and_foreclosure.pdf).

This situation can incentivize a servicer to encourage borrowers to pay on the junior mortgage it holds instead of on the senior one held by the trust.

### ***C. Trustees***

Legal title to the mortgage loans transferred to the trust is held by a trustee. The trustee is generally one of a handful of large financial institutions that specialize in corporate trust work. Trustees are selected by the securitization sponsors, not by the PLS investors, and most PLS sponsors have a “preferred trustee” that receives most of their business.

PLS trustees receive minimal compensation—typically 1 basis point (.01%) or less on the outstanding principal balance of the loans. Given this low level of compensation, it should not be surprising that PLS trustees believe that they have extremely limited ministerial duties prior to an event of default under the trust documents, such as a failure of a servicer to perform its contractual obligations. PLS trustees also believe that they have no duty to take notice of an event of default absent notification and indemnification by investors holding 25% of the voting rights of the PLS.

In other words, prior to notification of an event of default, these PLS trustees do not believe themselves to have any fiduciary obligations to the PLS investors. After an event of default, PLS trustees are tasked with acting in accordance with a prudent person standard, but because PLS investor lists are not public, even notifying a PLS trustee of an event of default is difficult.

Investors, moreover, lack ready access to the information necessary to determine if an event of default has occurred: the information about whether a servicer is meeting its contractual obligations regarding putbacks or advancing or prudently servicing loans is all in the hands of the servicer. The trustee could obtain this information, but trustees believe that they are under no duty to do so prior to an event of default. Thus, before PLS investors are able to spur a trustee to take action to protect their interests, they face the challenge of limited information available on which to determine if an event of default has occurred, the information problem of identifying other PLS investors in their deal, the collective action problem of coordinating the required threshold of PLS investors (who do not always have identical incentives and may trade in and out of their positions), and the expense of indemnifying the trustee.

The result is that PLS trustees are not motivated to be vigorous advocates for the rights of PLS investors. PLS trustees are unlikely to press servicers to diligently pursue putback claims for representation and warranty violations, to maximize recoveries on defaulted mortgages (either through smart modifications or by maximizing foreclosure sale returns), or to fulfill advancing obligations.

### ***D. No One’s Minding the Store***

Thus, while PLS trustees are supposed to oversee servicers, and servicers are supposed to oversee representations and warranties about the loans, the trustees are poorly motivated to oversee the servicers who are in turn poorly incentivized to prosecute violations of representations and warranties and who have incentives to take actions against the interest of the PLS investors. PLS investors, then, are entrusting their funds to agents (the trustee and servicer) who lack the proper incentives to protect the PLS investors’ interest and whom the PLS investors cannot easily discipline.

Given this situation, sponsors know that it is unlikely that they will be accountable for the representations and warranties they make about the loans they securitize. This in turn incentivizes sponsors to securitize loans of lower quality than represented and warranted. In other words, sponsors can knowingly or negligently sell grade B loans as grade A loans and collect a grade A price for the grade B loans because they know that they are unlikely to have to pay damages for breach of contract. The entire design of PLS encourages lack of care in underwriting, if not outright fraud.

### ***E. Limitations of Subordinated Debt (“B-Piece”) Investors to Provide Credit Diligence***

Absent adequate internal contractual protections (or regulation), there were only two real bulwarks against misrepresentation and fraud: diligence by subordinated debt investors and the reputational risk to sponsors. The economics of securitization are such that it is not profitable unless both the senior AAA-rated tranches (the “A-piece”) and the junior non-investment grade or unrated tranches (the “B-piece”) can be sold. While there was always significant demand for the A-piece because of the virtually unlimited market appetite for AAA-rated assets (especially those with higher yields than Treasuries) selling the B-piece was more difficult, and had to be done first.

Traditionally, there was a small, but sophisticated cohort of B-piece investors specialized in analyzing credit risk. These B-piece investors paid for access to loan tapes prior to deal closing and received “kickout” rights to remove mortgages that they did not like from the pools in which they invested. Prior to roughly 2004 it was not possible to sell a securitization that these traditional B-piece investors would not buy. The A-piece investors were thus able to piggyback on the diligence of the B-piece investors. Starting in roughly 2004, traditional B-piece investors began to be outbid for the B-piece by collateralized debt obligations (“CDOs”). CDO managers were not specialists in mortgage credit risk, but were simply looking to maximize their assets under management on which their compensation was based.<sup>17</sup>

The disappearance of the CDO market may help return B-piece investors as a check on credit quality in PLS, but also indicates that there is a definite ceiling to the potential size of the PLS market. One can use 2003 as a (generous) cutoff year to isolate out CDO-financed PLS from traditional B-piece buyer financed PLS. Using this cutoff indicates that traditional subordinated investors were never able to provide the credit risk assumption for more \$300 billion annually in housing finance in a market that has needed an average of about \$2.5 trillion in new investment, and as high as \$4 trillion in some years. Even optimistically assuming that the PLS market could provide \$500 billion in annual investment, this means that it is simply unrealistic to expect even a restored PLS market to be able to provide much more than a eighth of peak US housing finance needs and on average no more than a fifth.

### ***F. Reputational Sanctions Do Not Work in the Modern Financial Services World***

Reputational sanctions are unlikely to work in the modern financial services world. The reputation on the line is that of the PLS sponsors—institutional entities—but the gains from misrepresentation or fraud accrue to individual employees of those institutions in the form of immediate compensation. As these employees have very moveable human capital and are not linked to the long-term reputation of an institution, it is unclear whether reputational sanctions

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<sup>17</sup> MICHAEL LEWIS, *THE BIG SHORT* 142-43 (2010) (describing the incentives of Wing Chao, the largest CDO manager).

are sufficient to ensure the quality of securitized mortgages. Thus, a recent study by the Center for Public Integrity found that senior executives from all of the 25 top subprime lenders during 2005-2007 were back in the mortgage business as of 2013.<sup>18</sup> Similarly, it is easy enough to move from the securitization desk of a failed investment bank to another or to an investment fund. The lack of SEC and DOJ prosecution of either individuals or institutions related to pre-2008 PLS merely underscores the lack of consequences of securitizing non-complying mortgages. Thus, it is unlikely that reputational sanctions are sufficient to keep the PLS market in check.

### ***G. PLS Are a Lemons Market***

Given these circumstances, it should not be surprising that investors have been incredibly reluctant to return to the PLS market. Once burned, they are twice shy. The PLS market is the very incarnation of Nobel Prize winning economist George Akerloff's famous *Market for Lemons*.<sup>19</sup> And as Akerloff predicted would happen in a lemons market, the market collapsed because of lack of buyer confidence.

If investors are to return to the PLS market they will need to be confident that the mortgages backing the PLS are actually of the quality and characteristics promised and that if they are not, their warranty rights will be enforced. Ensuring that representations and warranties are vigorously enforced is necessary to ensure initial underwriting and documentation quality.

To ensure enforcement of investor rights requires reform of trustee compensation and duties, of servicing contracts, of diligence procedures, and of credit rating agencies. None of these are simple tasks. Increasing trustee duties, for example, will necessitate increasing trustee compensation, and that will result in higher mortgage costs. To the extent that PLS compete with other forms of mortgage financing, this will make PLS a less competitive financing execution.

## **III. THERE IS NO EVIDENCE THAT PLS CAN SUPPORT MORE THAN AN EIGHTH TO A QUARTER OF THE US HOUSING FINANCE MARKET'S CAPITAL NEEDS**

### ***A. The PLS Market Has Never Supported More Than a Fraction of America's Housing Finance Needs***

Based on the historical experience with PLS, it is unrealistic to expect PLS to be able to support more than a (generously optimistic) \$500 billion in annual investment in a US housing finance market that requires as much as \$4 trillion in annual investment (typical annual financing needs are more in the range of \$2 trillion). There is no evidence that there is a substantial body of capital eager to assume this much credit risk on U.S. mortgages *at any interest rate*, much less at rates that would not make mortgages prohibitively expensive for borrowers. Even if private-label MBS were structured to remove most credit risk from some securities (thereby concentrating it in others), few investors are likely to trust credit ratings on MBS in the foreseeable future.

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<sup>18</sup> See Daniel Wagner, *Subprime Lending Execs Back in Business Five Years After Crash*, CENTER FOR PUBLIC INTEGRITY, Sept. 11, 2013, at <http://www.publicintegrity.org/2013/09/11/13327/subprime-lending-exec-back-business-five-years-after-crash>.

<sup>19</sup> George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

## ***B. The Jumbo Market Does Not Provide Evidence of the Viability of a Large-Scale PLS Market***

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

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

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

The prime jumbo market does function without a government guarantee, but it also benefits from the existence of a government guarantee indirectly in multiple ways. For example, jumbo portfolio lenders hedge their interest rate risk by investing in GSE securities.<sup>20</sup> Advance rate lock-ins on jumbos are available because jumbo lenders can largely hedge their rate risk using the conforming To Be Announced (“TBA”) forward contract market. The jumbo market has also long aped the standards set by the GSEs in the conforming market, including amortization, maturity lengths, and appraisal standards. Finally, the jumbo market has benefitted from stability in housing prices and overall systemic stability created by the government guarantee in the conforming market given the serial correlation of housing prices. Indeed, the virtual disappearance of the jumbo market following the financial collapse in 2008 draws into question whether this market is in fact viable; the spillover benefits from the guarantee in the conforming market have not been enough to resuscitate the jumbo market.

All the existence of the jumbo market demonstrates is that there are *some* investors who are willing to assume credit risk on U.S. mortgages. It does not provide evidence that the PLS market can develop on sufficient scale to be the mainstay of the US housing finance system.

## **IV. THE PLS MARKET PRODUCES RISKIER MORTGAGES**

### ***A. The PLS Market Will Not Produce Widely Available 30-Year Fixed Rate Mortgages***

Privatization advocates also claim that the presence of jumbo 30-year fixed rate mortgages (“FRMs”) demonstrates that a private market will continue to produce 30-year

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<sup>20</sup> Frank E. Nothaft, *Lessons from the Jumbo Market*, 1996 Mortgage Market Trends 12 (1996).

FRMs.<sup>21</sup> This is a strawman argument. No one claims that the 30-year FRM will entirely disappear with privatization. Instead, privatization will turn it into a niche product that is not widely available to American families.

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

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

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

Indeed, overall, the PLS market has a definite bias toward ARMs and away from FRMs. From 2001-2008, 70% of all loans originated for PLS were adjustable-rate. In comparison, only 12% of loans originated for GSE securitization during this same period were adjustable-rate.<sup>22</sup>

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

The jumbo market does produce 30-year FRMs. But it only produces a very small number of them. Jumbos are only a small percentage of the market overall, and only a minority of jumbos are FRMs, and not all of those are 30-year maturities. Even in the extreme low-rate

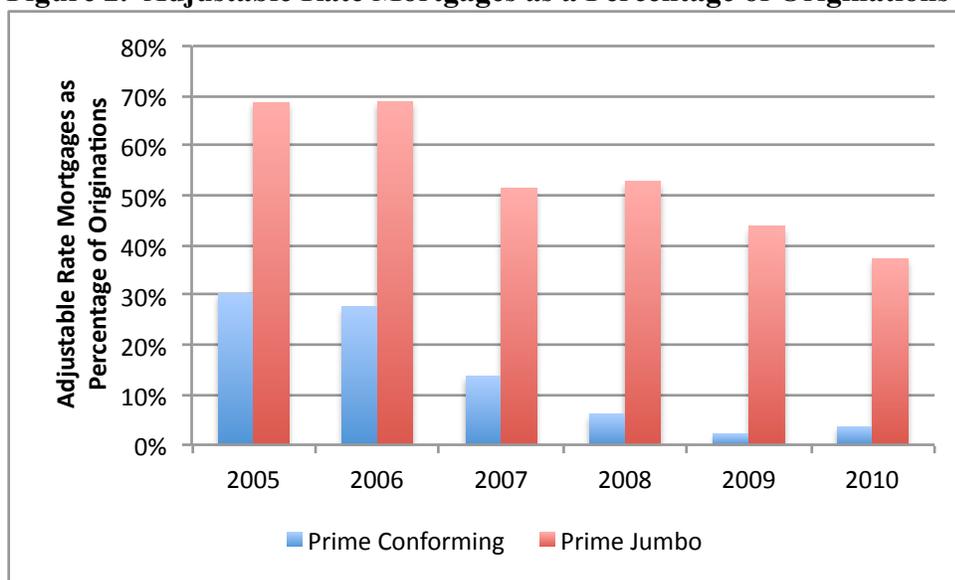
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<sup>21</sup> See, e.g., Testimony before the Senate Banking Committee, Peter Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute (Mar. 2013) (noting that there are Google results for the search "30-year jumbo fixed rate mortgage.")

<sup>22</sup> FHFA, *Data on the Risk Characteristics and Performance of Single-Family Mortgages Originated from 2001 through 2008 and Financed in the Secondary Market* 3 (2010); David Min, *How Government Guarantees in Housing Finance Promote Stability*, 50 HARV. J. LEG. 437, 482 (2013).

environment of 2009-2010, over a third of jumbos were adjustable rate mortgages (“ARMs”), compared with less than 5% of prime conforming loans. As Figure 1, below, shows, the jumbo market (Prime jumbos) contains a considerably higher percentage of ARMs than the GSE market (Prime Conforming). The private jumbo market simply does not produce very many 30-year FRMs. In fact, in recent years jumbo FRMs have been only 4% of the entire mortgage market. 30-year jumbo FRMs may be advertised on websites, as privatization proponents have noted,<sup>23</sup> but in practice they are rare. The existence of a small number of FRMs in the relatively small jumbo market is not a basis for assuming that the market will produce 30-year FRMs on any scale absent a government guarantee.

**Figure 2. Adjustable Rate Mortgages as a Percentage of Originations<sup>24</sup>**



### ***B. A PLS Market Will Make It Impossible for Homebuyers to Lock in Rates in Advance***

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

Homebuyers are able to lock in rates in advance because lenders are able to do so themselves by selling advance commitments in the form of forward contracts on the “To-Be-Announced” (“TBA”) market. The TBA market is a market of forward contracts in MBS. The TBA market exists only for GSE MBS; jumbos and other private-label MBS do not trade in the

<sup>23</sup> See Wallison, *supra* note 21.

<sup>24</sup> Emanuel Moench, James Vickery, & Diego Aragon, *Why Is the Market Share of Adjustable Rate Mortgages So Low?* 16 CURRENT ISSUES IN ECON. & FIN. 1, 3 (Fed. Reserve Bank of N.Y. 2010).

TBA market.<sup>25</sup> Thus, to the extent that a borrower can lock in a jumbo rate in advance, the lender must assume the rate risk in this duration. Lenders are willing to do so in part because they can largely hedge the rate risk on the jumbo through offsetting sales in the TBA market.

The TBA market is able to function because the GSEs' MBS are exempt from the registration requirements of the federal securities laws. Because the TBA market involves the sale of MBS *before the MBS have been created*, it is impossible for those MBS to be registered with the SEC.<sup>26</sup> Even with a registration exemption, however, a TBA market is not possible for PLS because they lack the high degree of fungibility that exists between GSE MBS, which is necessary as an economic matter to create a liquid forward contract market. There is variation among the GSE securities that trade in the TBA market, but they also all share three key features that help homogenize the GSE MBS: (1) all credit risk is held by the GSEs; (2) all are pass-through securities; and the (3) geographic composition of the pools cannot be determined by investors. The variations among GSE MBS that trade TBA are relatively minor.

A PLS market cannot support a TBA market, so relying solely on PLS would make it extremely difficult for borrowers to lock in mortgage rates 60-90 days before closing. Credit risk on PLS is held by PLS investors and would vary in part based on the financial strength of the issuer that makes the representations and warranties about the quality of the securitized mortgages. As a result, these securities are very likely to be structured to create credit enhancement, rather than pass-throughs. Structuring would destroy fungibility, as the credit enhancements would vary between individual MBS. And because investors would bear credit risk, they would demand to know information such as geographic composition of pools, as they already do for private-label MBS. Indeed, one of the factors the Kroll Bond Rating Agency explicitly lists as affecting their rating of PLS is the geographic composition of the mortgage pools.<sup>27</sup> Pre-closing rate-locks would not be standard in a PLS-financed system.

### ***C. The PLS Market Will Produce Geographic Price Discrimination and Systemic Risk***

The GSEs do not currently disclose the geographic make up of their pools pre-sale, and this prevents geographic price discrimination—there is no premium paid for living in parts of the country that are perceived of as riskier, either in terms of credit risk or in terms of prepayment risk (such as states with greater population mobility). Instead, in our current housing finance system, there is geographic cross-subsidization. In a PLS market, this cross-subsidization would disappear, with the likely result that the South and West would face higher mortgage rates, just as they did before the entry of the federal government into the housing finance market. Rural communities would also likely face higher credit costs.

Whatever one thinks of the distributional fairness of cross-subsidies, there is good reason to support its continuation, as it helps reduce systemic risk. Geographic price discrimination can result in self-fulfilling predictions of local housing bubbles and foster instability in the financial system.

For example, if there is a state budget crisis in Illinois (an all too real prospect), that could be expected to raise the costs of mortgage credit in Illinois, because state budget cuts could

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<sup>25</sup> So-called “conforming jumbos” or “high balance” conforming loans have traded in the TBA market since 2008, after the conforming loan limits were temporarily raised under the Economic Stimulus Act of 2008, but these loans are guaranteed by the GSEs and should not be confused with traditional Jumbos.

<sup>26</sup> 12 U.S.C. § 1455(g) (Freddie Mac exemption); 12 U.S.C. 1717(c) (Fannie Mae exemption).

<sup>27</sup> Kroll Bond Rating Agency, RMBS: Transaction Comparison Report (9-19-13).

affect local housing values. Higher costs of credit would depress Illinois housing prices, which would in turn raise default rates and result in yet higher cost so mortgage credit in Illinois, creating a vicious cycle. Thus, it would be easy for local housing price collapses to be spurred by largely unrelated events, and there is a risk of a cascade across local markets. What's more, the flightiness of capital from PLS markets—as illustrated by the PLS market's precipitous collapse in 2008—means that the capital necessary to support housing prices will not be available precisely at the times it is most needed.

## **V. POTENTIAL REFORMS OF PLS AND THEIR LIMITATIONS**

### ***A. Experiments in Recent PLS Deal Structures: One Step Forward, One Step Back***

The PLS deals issued since 2008 have begun to experiment with deal design, reflecting, in part, some of the learning going on in the commercial mortgage securitization market, which has rebounded more successfully than the PLS market (although CMBS is only back to around 25% of its 2007 peak), under the auspices of a separate trade association.<sup>28</sup> I will refer to these post-2008 PLS deals as “PLS 2.0.”

PLS deal structures are one step forward, one step backward, and for fundamental issues simply trading water. Often improvements in some areas are offset by regression in others. Thus, Moody's Investor Services noted that JPMorgan Mortgage Trust (JPMMT) 2013-1 PLS would not likely achieve a AAA rating despite having “strong originators, provides better data than pre-crisis deals, and the collateral consists of high quality loans with low loan-to-value ratios (LTVs) and high borrower credit scores” because “the transaction has a weak representations and warranties (R&W) framework coupled with a restrictive enforcement mechanism. In addition, neither JPM nor any of its affiliates are retaining any credit risk and JPM is holding all the collateral files for the loans in the pool.”<sup>29</sup>

Among the improvements in PLS 2.0 are provisions regarding access to investor lists<sup>30</sup> and directing trustees to take notice of breaches of originator representations and warranties without direction from investors.<sup>31</sup> Particularly significant is the introduction in the Sequoia deals of a party called the “Controlling Holder,” which is required to engage a third-party to undertake a review of all loans that are 120 days delinquent for breaches of originator representation and warranties.<sup>32</sup> This third party cannot have conducted the pre-securitization review of the loans.<sup>33</sup> The Trustee is then charged with pursuing breaches of originator

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<sup>28</sup> The CMBS market is represented by the Commercial Real Estate Finance Council, while the PLS market has the American Securitization Forum representing the sell side, and, more recently the Association of Mortgage Investors representing the buy side.

<sup>29</sup> Moody's Investor Service, *New JP Morgan RMBS Has Structural Weaknesses, Falls Short of AAA*, Mar. 25, 2013, at [https://www.moody.com/research/Moodys-New-JP-Morgan-RMBS-has-structural-weaknesses-falls-short-PR\\_269473](https://www.moody.com/research/Moodys-New-JP-Morgan-RMBS-has-structural-weaknesses-falls-short-PR_269473).

<sup>30</sup> E.g., SEMT-2013-8, ¶ 8.02.

<sup>31</sup> E.g., SEMT-2012-5, ¶ 2.05(a)(ii).

<sup>32</sup> E.g., SEMT-2012-5, ¶ 2.05(b). This is most likely not a structure that banks can easily replicate because the combination of control and upside/downside risk means that the entire securitization should remain on balance sheet under SFAS 166, thereby vitiating the regulatory capital relief benefit of securitization, as risk based capital charges take GAAP-based balance sheets as their starting point.

<sup>33</sup> *Id.*

representations and warranties.<sup>34</sup> This structure at first glance seems well designed to enforce the *originators'* representations and warranties, but its effectiveness is mitigated by the requirement that putbacks to being done on a loan-by-loan basis,<sup>35</sup> rather than through a sampling methodology, as has been approved by courts. Moreover, the controlling holder is *not* a fiduciary,<sup>36</sup> and other investors are not given any explicit rights in regard to the controlling holder, so if the controlling holder fails to fulfill its obligations, it is unclear what recourse investors have against it.

As I read the relevant PSAs, moreover, the Controlling Holder provisions relate only to prosecuting representations and warranties by originators, not by sellers or depositors. This is particularly concerning because the Controlling Holder is an affiliate of the sponsor and the depositor. Only the Trustee (chosen by the sponsor) is charged with handling sponsor/depositor breaches of representations and warranties, but the Trustee is only authorized to do so upon receiving notice of a breach...and that notice may only come from the sponsor or depositor. In other words, the sponsor and depositor representations are solely on the honor system.

Some PLS 2.0 provisions are downright regressive. Instead of requiring 25% of all votes in a deal to make a demand on the trustee to act, PLS 2.0 deals are requiring 25% of the votes in *each* tranche.<sup>37</sup> This makes it near impossible for investors to make a demand on the trustee to act; a single investor in a single tranche can block enforcement. Given that the deal sponsor's affiliate is the holder of the junior tranche, this means that enforcement will only happen if the deal's sponsor wants it to; other investors are at the sponsor's mercy. The prohibition on sampling for putbacks is similarly regressive. What appears to be occurring in PLS 2.0 is that investors are given formal rights, but then presented with procedural obstacles to enforcing them. It would be all too easy for most investors never to notice this until after they're invested.

Most troubling with PLS 2.0 is that there is no change in the way trustees and servicers are selected, in their duties, or in their compensation. PLS 2.0 has shown some willingness to experiment, but none of the changes are likely to restore investor trust in PLS as an asset class. More work needs to be done to restart the PLS market.

### ***B. Potential Reforms of the PLS Market***

There are several possible reforms that could be undertaken to increase investor trust in the PLS market. First, PLS would benefit from greater standardization ranging from loan underwriting and documentation practices to aggregation and securitization practices to securitization documentation to securitization structures. Promoting such standardization should be a goal of any housing finance reform bill, as standardization will make the housing finance market more liquid and also facilitate investor diligence.<sup>38</sup>

Heterogeneity among PLS deals makes it difficult for investors to compare. If deals differed on say five dimensions, it would be far easier for investors to evaluate the relative risks of deals than if they varied on five hundred dimensions. There is no reason why boilerplate language should vary among securitization documents, and minimum investor protections should

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<sup>34</sup> *Id.*

<sup>35</sup> SEMT 2013-1, ¶ 2.04(a).

<sup>36</sup> E.g., SEMT 2012-5, ¶ 2.07(b).

<sup>37</sup> SEMT 2013-8, ¶ 6.18.

<sup>38</sup> Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1252-58 (2012).

be standardized so investors can count on a baseline of protections in all deals. Proposals like that in S.1217 regarding uniform securitization agreements are an important step in the right direction.<sup>39</sup>

Second, and relatedly, the Trust Indenture Act of 1939 should be updated to provide clear basic minimum standards for the duties of trustees and servicers in PLS and investors rights. The Trust Indenture Act is the major legal protection for bondholders, and it governs the duties and standards applicable to indenture trustees. There is debate (and pending litigation) about whether the Trust Indenture Act currently applies to PLS. The answer may depend on the individual deal, but PLS trustees believe that in most cases it does not apply. Irrespective of whether the Trust Indenture Act currently applies to PLS, it should, although it should also be updated and revised to account for specific problems in PLS.

In particular the Trust Indenture Act should forbid trustees or whatever party is responsible for protecting the rights of PLS investors from having any conflicts of interest. This would at the very least forbid investment in PLS by the trustee or its affiliates. It should also forbid other business relationships with sponsors and depositors. The trustee or party responsible for protecting the rights of PLS investors should also be an express fiduciary to all the PLS investors. Similar requirements might be extended to servicers, and servicers should be prohibited from servicing first liens on which they or their affiliates own the junior liens.

A third possibility is to reform the role of PLS trustees. PLS trustees perform several different functions: some ministerial reporting work for the trust, enforcement of the PSA, and serving as the backup master servicer (in case of the servicer's bankruptcy). These roles could be divided. A separate trust administrator can perform the ministerial functions (and does in some PLS 1.0 deals). The backup master servicing role could be contracted out to another master servicer (and indeed, that is all most trustees would do if they had to take over the servicing). And the role of PSA enforcement could be given to a specialized enforcement party. That specialized enforcement party would not need to maintain significant standing capacity and could be paid a small regular retainer except when its duties were required, at which point it could be paid on a fee for services model.

Some of the PLS 2.0 deals take steps in this direction. The "Controlling Holder" mechanism charges the juniormost investor with retaining an independent investigator of all 120+ day delinquent loans for originator representation and warranty violations. Similarly, commercial mortgage-backed securities automatically transfer all loans that run 60 days delinquent to a special servicer chosen by the juniormost in-the-money tranche. That special servicer is compensated with a vertical slice of the loan so as to align its incentives with those of the CMBS investors as a whole.

There are problems with both of these structures, even though they are moves in the right direction. The main problem is that enforcement mechanism is controlled by a single investor that may not share the interests of the other investors. Indeed, this is a fundamental problem with tranced securitizations—investors with different interests are tied together in the same deal structure. Giving enforcement rights to one single investor sets up potential conflicts of interest, particularly when that investor is also an affiliate of the sponsor, as in the Sequoia deals. PLS

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<sup>39</sup> S.1217, § 223.

investors cannot rely on sponsors to police themselves, and none of the PLS 2.0 structures fundamentally change the selection, duties, or compensation of the trustee.

Ultimately, changes in PLS deal structures—either by market experimentation or by regulation—might help develop trust between PLS investors and the PLS sponsors, servicers, and trustees. But these changes will not restore investor trust in credit ratings. A discussion of the problems in credit ratings is beyond the scope of my testimony today, but trust in ratings is which is necessary back the “safe” interest-rate-risk-only investors back into PLS and for AAA-rated PLS to again be accepted as collateral in repo and securities lending markets without haircuts from par. Unless both the PLS deal structures *and* the credit rating agencies are fixed, it is hard to imagine PLS ever expanding beyond the ultra-prime PLS 2.0 deals and growing to more than a marginal market share.

### **CONCLUSION: THE ILLUSION OF WHOLLY PRIVATE HOUSING FINANCE SYSTEMS**

The government’s involvement in the U.S. housing finance system carries with it serious concerns of moral hazard, socialized losses and privatized gains, and politicized underwriting. The PLS market, however, is not a solution. Despite privatization’s ideological appeal, there is a fundamental problem with privatization proposals for the housing finance system: they don’t work. Fully private housing finance systems simply do not exist in the developed world.

PLS are not and have never been a totally private system. To the extent that sponsors are too-big-to-fail financial institutions, their representations and warranties benefit from the implicit government guaranty. Moreover, these institutions benefitted from piggybacking on the GSE market in numerous ways

Every other developed country either explicitly or implicitly guarantees some part of its housing finance system. In some countries, like Canada, the guarantee is explicit—and priced—and the market is regulated to protect the government from excessive risk exposure. In other countries, the guarantee is implicit.<sup>40</sup> It is difficult to prove an implicit guarantee; the very nature

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<sup>40</sup> Proponents of privatizing the housing finance system and eliminating the government guarantee will generally point to Germany and Denmark as examples of housing finance systems without a guarantee that have widely available long-term, fixed-rate mortgages. E.g., Peter J. Wallison, *A New Housing Finance System for the United States*, Mercatus Center Working Paper No. 11-08, at [http://mercatus.org/sites/default/files/publication/wp1108-a-new-housing-finance-system-for-the-united-states\\_0.pdf](http://mercatus.org/sites/default/files/publication/wp1108-a-new-housing-finance-system-for-the-united-states_0.pdf), at 10 (“Neither Denmark nor Germany backs any part of the mortgage financing system, which seems to work well because of the regulatory assurances of mortgage quality.”). Unfortunately, this view of the German and Danish housing finance systems is incorrect. Germany and Denmark both turn out to have been latent implicit guarantee cases prior to October 2010, at which point they became examples of explicit guarantees.

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

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

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

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

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

There are ways to try to guard against both problems. For example, moral hazard can be alleviated through use of deductibles and copayments—have first-loss private risk capital or loss splitting between the government and private capital. Administrative structures can guard against politicized underwriting. Those risk mitigants, however, require an explicit guarantee. I am pleased to see that this problem is well understood by S.1217, and I offer some suggested improvements to that bill below, in an appendix.

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

I would urge this Committee to not pursue a path of housing finance reform that relies on PLS providing the backbone of the market. If housing finance reform relies on the PLS market to provide the financing for American's homes, we will witness a nationwide decline in home prices unless the PLS market somehow figures out how to generate trillions in financing that it never has previously provided.

Relying on PLS to serve as the main financing source for the housing market would be a high-risk gamble with the US economy. Instead, a hybrid public-private system with first-loss private capital backstopped by an explicit and priced government guarantee, such as that proposed by S.1217,<sup>41</sup> should provide the basic template for housing finance reform.

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deposits and senior debts of the banks that issued them. The functional reality of this arrangement, however, was to guarantee the covered bonds by guaranteeing that the issuers would have sufficient assets and liquidity to meet their covered bond payment obligations so that the covered bondholders would never have to look to their cover pools of collateral for recovery.

<sup>41</sup> S. 1217, § 204(a).

**APPENDIX: SUGGESTED IMPROVEMENTS TO S.1217, THE “HOUSING FINANCE REFORM AND TAXPAYER PROTECTION ACT OF 2013”**

The conceptual framework of a hybrid public-private housing finance system embodied in S.1217 is fundamentally sound. That said, there are three areas in which I would suggest some important substantive changes to S.1217, in addition to various smaller technical changes.

**(1) *S.1217 should explicitly task the proposed Federal Mortgage Insurance Company (FMIC) with adopting policies aimed at ensuring specific market results regarding product availability.***

S.1217 should explicitly task the proposed Federal Mortgage Insurance Company (FMIC) with adopting policies aimed at ensuring specific market results regarding product availability. Specifically, section 201(a) of S.1217 should expressly charge the FMIC with ensuring the continued wide-spread availability of the 30-year fixed rate mortgage, pre-closing rate locks, a robust TBA market, fair access and affordability, and support for multifamily housing options.<sup>42</sup> FMIC should also be charged with ensuring against geographic price discrimination. It is easy to forget that housing finance is only a means of furthering housing policy. Charging FMIC with specific policy outcomes will help ensure that the market retains prized features of the existing housing finance system. Delegating authority to FMIC to figure out how to achieve these results within the statutory framework provided by S.1217 will avoid the problem of Congress attempting to draft overly restrictive statutory language for a developing market.

**(2) *S.1217 should provide a more robust framework for regulating bond guarantors.***

That said, the regulatory regime for bond guarantors in S.1217 is insufficient to ensure safety-and-soundness. S.1217 would have the FMIC would license these guarantors,<sup>43</sup> but FMIC would have few intermediary regulatory tools short of refusing to renew a license. Tools like Prompt Corrective Action directives and the ability to levy monetary penalties and cease and desist orders have not been especially successful in the regulation of depositories, but should at least be added to FMIC’s toolbox, and FMIC should have the authority to regulate bond guarantors to avoid granular risk-based pricing, prevent creaming, and ensure good reinsurance practices. Likewise, FMIC should have the express authority to clawback compensation from executives of bond guarantors that have engaged in malfeasance resulting in a loss to FMIC.

**(3) *S.1217 should level the playing field between bond guarantors and capital markets.***

S.1217 contemplates the 10% first loss position being supported either by capital markets investors or by bond guarantors.<sup>44</sup> As currently drafted S.1217 would seem to favor capital markets as the bill seems to establish a capital requirement of 100% equity for bond guarantors’ support of the 10% first loss position,<sup>45</sup> and requires FMIC to monitor safety and soundness of bond guarantors—albeit without all of the necessary tools, as discussed above—but not of capital

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<sup>42</sup> Ensuring the existence of a TBA market will likely require the use of a single-security that is good delivery for obligations irrespective of the identity of the bond guarantor, if the 10% first loss position is guaranteed by a bond guarantor.

<sup>43</sup> S.1217, § 214.

<sup>44</sup> S.1217, § 202(a)(2).

<sup>45</sup> S.1217, § 214(a)(2).

markets issues. To the extent that capital markets executions are favored by S.1217, it would limit the capital available for PLS.

S.1217 could be improved by leveling the playing field for bond guarantors. Their capital requirements should not be different from those of issuers and should be set on the actuarially appropriate amount required for the risk, rather than at 100% equity. They should also not be subject to any sort of “stop-loss”—they should have to pay out on claims until their funds are exhausted. Likewise, the regulatory standards applied to bond guarantors should apply to all credit-risk takers, including capital markets executions.