Testimony Concerning "Securitization of Assets: Problems and Solutions"

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Good afternoon Chairman Reed, Ranking Member Bunning and Members of the Subcommittee. I am Bill Irving, an employee of Fidelity Investments,[1] where I manage a number of fixed-income portfolios and play a leading role in our investment process in residential mortgage-backed securities (RMBS). This experience has certainly shaped my perspective on the role of securitization in the financial crisis, the condition of the securitization markets today, and policy changes needed going forward. I thank you for the opportunity to share that perspective with you in this hearing. At the outset, I want to emphasize that the views I will be expressing are my own, and do not necessarily represent the views of my employer, Fidelity Investments.

Summary

I will make three main points. First, the securitized markets provide an important mechanism for bringing together investors and borrowers to provide credit to the American people for the financing of residential property, automobiles, and retail purchases. Securitization also provides a major source of funding for American

[1] Fidelity Investments is one of the world's largest providers of financial services, with assets under administration of $3.0 trillion, including assets under management of more than $1.4 trillion as of August 31, 2009. Fidelity offers investment management, retirement planning, brokerage, and human resources and benefits outsourcing services to over 20 million individuals and institutions as well as through 5,000 financial intermediary firms. The firm is the largest mutual fund company in the United States, the No. 1 provider of workplace retirement savings plans, the largest mutual fund supermarket and a leading online brokerage firm. For more information about Fidelity Investments, visit Fidelity.com.

businesses for commercial property, agricultural equipment and small-business investment. My second point is that the rapid growth of the markets led to some poor securitization practices. For example, loan underwriting standards got too loose as the interests of issuers and investors became mis-aligned. Furthermore, liquidity was hindered by a proliferation of securities that were excessively complex and customized. My third and final point is that in spite of these demonstrated problems, the concept of asset securitization is not inherently flawed; with proper reforms to prevent weak practices, we can harness the full potential of the securitization markets to benefit the U.S. economy.

Brief Review of the Financial Crisis

To set context, I will begin with a brief review of the financial crisis. This view is necessarily retrospective; I do not mean to imply that investors, financial institutions or regulators understood all these dynamics at the time. In the middle of 2007, the end of the U.S. housing boom revealed serious deficiencies in the underwriting of many recently originated mortgages, including sub-prime loans, limited-documentation loans, and loans with exotic features like negative amortization. Many of these loans had been packaged into complex and opaque mortgage-backed securities (MBS) that were distributed around the world to investors, some of whom relied heavily on the opinion of the rating agencies and did not sufficiently appreciate the risks to which they were exposed.[2]

The problems of poorly understood risks in these complex securities were amplified by the leverage in the financial system. For example, in 2007, large U.S. investment banks

[2] At Fidelity, we consider the opinions of the rating agencies, but we also do independent credit research on each issuer or security we purchase.

had about $16 of net assets for each dollar of capital.[3] Thus, a seemingly innocuous hiccup in the mortgage market in August 2007 had ripple effects that quickly led to a radical reassessment of what is an acceptable amount of leverage. What investors once deemed safe levels of capital and liquidity were suddenly considered far too thin. As a result, assets had to be sold to reduce leverage. This selling shrank the supply of new credit and raised borrowing costs. In fact, the selling of complex securities was more than the market could bear, resulting in joint problems of liquidity and solvency. Suddenly, a problem that had started on Wall Street spread to Main Street. Companies that were shut off from credit had to cancel investments, lay off employees and/or hoard cash. Many individuals who were delinquent on their mortgage could no longer sell their property at a gain or refinance; instead, they had to seek loan modifications or default.

This de-leveraging process created a vicious cycle. Inability to borrow created more defaults, which led to lower asset values, which caused more insolvency, which caused more de-leveraging, and so forth. Home foreclosures and credit-card delinquencies rose, and job layoffs increased, helping to create the worst recession since the Great Depression.

Role Played by Asset Securitization in the Crisis

Without a doubt, securitization played a role in this crisis. Most importantly, the "originate-to-distribute" model of credit provision seemed to spiral out of control. Under this model, intermediaries found a way to lend money profitably without worrying if the loans were paid back. The loan originator, the warehouse facilitator, the security

[3] Source: SNL Financial, and company financials.

designer, the credit rater, and the marketing and product-placement professionals all received a fee for their part in helping to create and distribute the securities. These fees were generally linked to the size of the transaction and most of them were paid up front. So long as there were willing buyers, this situation created enormous incentive to originate mortgage loans solely for the purpose of realizing that up-front intermediation profit.

Common sense would suggest that securitized assets will perform better when originators, such as mortgage brokers and bankers, have an incentive to undertake careful underwriting. A recent study by the Federal Reserve Bank of Philadelphia supports this conjecture.[4] The study found evidence that for prime mortgages, private-label securitized loans have worse credit performance than loans retained in bank portfolios. Specifically, the study found that for loans originated in 2006, the two-year default rate on the securitized loans was on average 15 percent higher than on loans retained in bank portfolios. This observation does not necessarily mean that issuers should be required to retain a portion of their securities, but in some fashion, the interests of the issuers and the investors have to be kept aligned.

Flawed security design also played a role in the crisis. In its simplest form, securitization involves two basic steps. First, many individual loans are bundled together into a reference pool. Second, the pool is cut up into a collection of securities, each having a distinct bundle of risks, including interest-rate risk, prepayment risk, and credit risk. For

[4] Elul, Ronel, "Working Paper No. 09-21 Securitization and Mortgage Default: Reputation Vs. Adverse Selection" Federal Reserve Bank of Philadelphia. September 22, 2009.

example, in a simple sequential structure, the most senior bond receives all available principal payments until it is retired; only then does the second most senior bond begin to receive principal; and so on. In the early days of securitization, the process was kept simple, and there were fewer problems. But over time, cash-flow rules grew increasingly complex and additional structuring was employed. For example, the securities from many simple structures were re-bundled into a new reference pool, which could then be cut into a new set of securities. In theory, there is no limit to the amount of customization that is possible. The result was excessive complexity and customization. The complexity increased the challenge of determining relative value among securities, and the non-uniformity hurt liquidity when the financial system was stressed.

One example of poor RMBS design is the proliferation of securities with complex rules on the allocation of principal between the senior and subordinate bonds. Such rules can lead to counter-intuitive outcomes in which senior bonds take write-downs while certain subordinate bonds are paid off in full. A second example of poor design is borrower ability to take out a second-lien mortgage without notifying the first-lien holder. This ability leads to a variety of thorny issues, one of which is simply the credit analysis of the borrower. If a corporation levered further, the senior unsecured debt holder would surely be notified, but that is not so in RMBS.

Other Factors Contributing to the Crisis

Securitization of assets played a role in the crisis, but there were several additional drivers. Low interest rates and a bubble mentality in the real-estate market also contributed to the problem. Furthermore, in the case of securitized assets, there were plenty of willing buyers, many of them highly levered. In hindsight, this high demand put investors in the position of competing with each other, making it difficult for any of them to demand better underwriting, more disclosure, simpler product structures, or other favorable terms. Under-estimation of risk is always a possibility in capital markets, as the history of the stock market amply demonstrates. That possibility does not mean that capital markets, or asset securitization, should be discarded.

Benefits of Asset Securitization

When executed properly, there are many potential benefits of allowing financial intermediaries to sell the loans they originate into the broader capital markets via the securitization process. For one, this process provides loan originators much wider sources of funding than they could obtain through conventional sources like retail deposits. For example, I manage the Fidelity Ginnie Mae Fund, which has doubled in size in the past year to over $7 billion in assets; the MBS market effectively brings together shareholders in this Ginnie Mae Fund with individuals all over the country who want to purchase a home or refinance a mortgage. In this manner, securitization breaks down geographic barriers between lenders and borrowers, thereby improving the availability and cost of credit across regions.

A second benefit of securitization is it generally provides term financing which matches assets against liabilities; this stands in contrast to the bank model, a substantial mismatch can exist between short-term retail deposits and long-term loans. Third, it expands the availability of credit across the country's socio-economic spectrum, and provides a mechanism through which higher credit risks can be mitigated with structural enhancements. Finally, it fosters competition among capital providers to ensure more efficient pricing of credit to borrowers.

Current Conditions of Consumer ABS and Residential MBS Markets

At present, the RMBS and ABS markets are sharply bifurcated. On one side are the sectors that have received government support, including consumer ABS and Agency MBS (i.e., MBS guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae); these sectors are, for the most part, functioning well. On the other side are the sectors that have received little or no such support, such as the new-issue private-label RMBS market, which remains stressed, resulting in a lack of fresh mortgage capital for a large segment of the housing market.

Consumer ABS

The overall size of the consumer debt market is approximately $2.5 trillion;[5] this total includes both revolving debt (i.e., credit-card loans) and non-revolving debt (e.g., auto and student loans). Approximately 75% takes the form of loans on balance sheets of financial institutions, while the other 25% has been securitized.[6]

From 2005 through the third quarter of 2008, auto and credit card ABS issuance ranged between $160 billion and $180 billion per year.[7] However, after the collapse of Lehman Brothers in September 2008, new issuance came to a virtual halt. With the ABS market effectively shut down, lenders tightened credit standards to where only the most credit worthy borrowers had access to credit. As a result, the average interest rate on new-car

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[5] Source: Federal Reserve, www.federalreserve.gov/releases/g19/current/g19.htm
[6] Source: Federal Reserve, www.federalreserve.gov/releases/g19/current/g19.htm
[7] Source: Bloomberg

loans provided by finance companies increased from 3.28% at end of July 2008 to 8.42% by the end of 2008.[8]

Issuance did not resume until March 2009 when the Term Asset-Backed Securities Loan Facility (TALF) program began. Thanks to TALF, between March and September of this year, there has been $91 billion of card and auto ABS issuance.[9] Coincident with the resumption of a functioning auto ABS market, the new-car financing rate fell back into the 3% range and consumer access to auto credit has improved, although credit conditions are still more restrictive than prior to the crisis. While TALF successfully encouraged the funding of substantial volumes of credit card receivables in the ABS market, it is worth noting that credit card ABS issuance has recently been suspended due to market uncertainty regarding the future regulatory treatment of the sector.

While interest rates on top tier New Issue ABS are no longer attractive for investors to utilize the TALF program, TALF is still serving a constructive role by allowing more difficult asset types to be financed through securitization. Examples include auto dealer floorplans, equipment loans to small businesses, retail credit cards, non-prime auto loans, and so forth.

Residential MBS

The overall size of the residential mortgage market is approximately $10.5 trillion, which can be decomposed into three main categories:

[8] Federal Reserve, www.federalreserve.gov/releases/g19/hist/cc_hist_tc.html
[9] Source: Bloomberg

1. Loans on bank balance sheets:[10] $3.5 trillion

2. Agency MBS:[11] $5.2 trillion.
   a. Fannie Mae: $2.7 trillion
   b. Freddie Mac: $1.8 trillion
   c. Ginnie Mae: $0.7 trillion
3. Private-Label MBS:[12] $1.9 trillion.
   a. Prime: $0.6 trillion
   b. Alt-A: $0.8 trillion
   c. Sub-prime: $0.5 trillion

Thanks to the extraordinary government intervention over the past year, the Agency MBS market is performing very well. This intervention had two crucial components. First, on September 7, 2008, the director of the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac into conservatorship. This action helped reassure tens of thousands of investors in Agency unsecured debt and mortgage-backed securities that their investments were supported by the federal government, in spite of the sharp declines in home prices across the country. The second component of the government intervention was the Federal Reserve's pledge to purchase $1.25 trillion of Agency MBS by the end of 2009.

Year to date, as of the end of September 2009, the Fed had purchased $905 billion Agency MBS, while net supply was only $448 billion.[13] Thus, the Fed has purchased roughly 200% of the year-to-date net supply. Naturally, this purchase program has reduced the spread between the yields on Agency MBS and Treasuries; we estimate the

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[10] Source: Federal Reserve, www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm
[11] Source: eMBS, www.embs.com
[12] Source: Loan Performance
[13] Source: JP Morgan, "Fact Sheet: Federal Reserve Agency Mortgage-Backed Securities Purchase Program"

reduction to be roughly 50 basis points. As of this week, the conforming-balance[14] 30-year fixed mortgage rate is approximately 4.85%, which is very close to a generational low.[15]

In contrast, the new-issue private-label MBS market has received no government support and is effectively shut down. From 2001 to 2006, issuance in this market had increased almost four-fold from $269 billion to $1,206 billion.[16] But when the financial crisis hit, the issuance quickly fell to zero. Issuance in 2007, 2008 and 2009 has been $759 billion, $44 billion and $0, respectively.[17] Virtually the only source of financing for mortgage above the conforming-loan limit (so-called Jumbo loans) is a bank loan. As a result, for borrowers with high-credit quality, the Jumbo mortgage rate is about one percentage point higher than its conforming counterpart.[18]

At first glance, the higher cost of Jumbo financing may not seem to be an issue that should concern policymakers, but what is bad for this part of the mortgage market may implications for other sectors. If the cost of Jumbo financing puts downward pressure on the price of homes costing (say) $800,000, then quite likely there will be downward pressure on the price of homes costing $700,000, and so forth. Pretty soon, there is downward pressure on homes priced below the conforming limit. In my opinion, at the same time that policymakers deliberate the future of the Fannie Mae and Freddie Mac,

[14] As of 2009, for the contiguous states, the District of Columbia and Puerto Rico, the general conforming limit is $417,000; for high-cost areas, it can be as high as $729,500.
[15] Source: HSH Associates, Financial Publishers
[16] Source: Loan Performance
[17] Source: Loan Performance
[18] Source: HSH Associates, Financial Publishers

they should consider the future of the mortgage financing in all price and credit-quality tiers.

Recommended Legislative and Regulatory Changes

The breakdown in the securitization process can be traced to four root causes: aggressive underwriting, overly complex securities, excessive leverage, and an over-reliance on the rating agencies by some investors. Such flaws in the process have contributed to the current financial crisis. However, when executed properly, securitization can be a very effective mechanism to channel capital into our economy to benefit the consumer and commercial sectors. Keep in mind that securitization began with the agency mortgage market, which has successfully provided affordable mortgage financing millions to U.S. citizens for over 35 years.[19] To ensure that the lapses of the recent past are not repeated, I recommend that regulatory and legislative efforts be concentrated in four key areas.

First, promote improved disclosure to investors at the initial marketing of transactions as well as during the life of the deal. For example, originators should provide detailed disclosure on the collateral characteristics and on exceptions to stated underwriting procedures. Furthermore, there should be ample time before a deal is priced for investors to review and analyze a full prospectus, not just a term sheet.

Second, strong credit underwriting standards are needed in the origination process. One way to support this goal is to discourage the up-front realization of issuers' profits. Instead issuers' compensation should be aligned with the performance of the security over its full life. This issue is complex, and will likely require specialized rules, tailored to each market sector.

[19] Fannie Mae, Freddie Mac and Ginnie Mae issued their first MBS in 1981, 1971, and 1970, respectively. Source: "Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises Long-term Structures" GAO Report to Congressional Committees, September, 2009.

Third, facilitate greater transparency of the methodology and assumptions used by the rating agencies to determine credit ratings. In particular, there should be public disclosure of the main assumptions behind rating methodologies and models. Furthermore, when those models change or errors are discovered, the market should be notified.

Fourth, support simpler, more uniform capital structures in securitization deals. This goal may not readily be amenable to legislative action, but should be a focus of industry best practices.

Taking such steps to correct the defects of recent securitization practices will restore much-needed confidence to this critical part of our capital markets, thereby providing improved liquidity and capital to foster continued growth in the U.S. economy.