Statement of Andrew Davidson

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before the

United States Senate Committee on Banking, Housing and Urban Affairs

Subcommittee on Securities, Insurance, and Investment

"Returning Private Capital to the Mortgage Markets:

A Fundamental for Housing Finance Reform"

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Mr. Chairman and Members of the Subcommittee:

Thank you for this opportunity to discuss returning private capital to the mortgage markets. Private capital investment in the mortgage market can be bifurcated into "Rates" investing and "Credit" investing. Rates investors bear interest rate risk and prepayment risk, but generally seek to avoid credit risk. Private capital Rates investors provide trillions of dollars to the mortgage backed securities market through investments in MBS guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae. This component of the market has performed extremely well through the financial crisis. Prior to the crisis, there was also a significant amount of Rates investing through the triple-A sector of the private-label mortgage market. This sector has largely vanished since the crisis.

Credit investors take on the risk of not receiving full and timely payment of principal and interest, generally due to the inability or unwillingness of the borrower to make payments and the inadequacy of collateral to cover the debt. Prior to the crisis, private capital provided funds for Credit investing through a variety of vehicles including investment in Government Sponsored Enterprise (GSE) stock, investment in Mortgage Insurer (MI) stock and through investment in subordinated classes of private-label securitizations. During the crisis, virtually all the equity of the GSEs and MI companies was wiped out, and the GSEs were placed in conservatorship. The mortgage market now primarily relies on the US Government bearing the credit risk of newly originated mortgages via FHA guarantees and Treasury's preferred stock investment in the GSEs.

While it is generally well known that there is significant amount of private capital in Rates investing in guaranteed MBS, it is less well known that there is still a significant amount of Credit investing in the private-label mortgage market. Of the approximately $2.2 trillion dollars

of private-label mortgages at the peak of the market, there is still approximately $900 billion of private-label mortgages outstanding. Approximately $800 billion of those securities are exposed to credit risks and do not meet the highest credit standards. Assuming an average price of 75, there is over $600 billion currently invested private-label securities that bear credit risk. Much of that investment was unanticipated, as investments that were thought to be low risk turned out to be exposed to credit risk. On the other hand, since the crisis, a significant portion of the bonds have been bought by Credit investors seeking to invest opportunistically. Due to the size of exposure the market has developed the analytical and investment infrastructure to manage this risk.

Table: Major forms of investment in the mortgage market
(grey indicates markets which were severely diminished by the crisis)

	RATES	CREDIT
GSE (Fannie, Freddie)	Government Guarantee TBA/MBS	Corporate Guarantee GSE equity MI equity
Private-Label (non-agency)	Non-Government Guarantee AAA/Senior	Collateralized Credit Enhancement Subordinated Credit-linked note

Private Capital in the GSE vs. Private-Label Markets

Today, there is a substantial amount of continuing and new Rates investment in the GSE mortgage market, but little Credit investment. Conversely, there is substantial continuing and new Credit investment in the private-label market, but little Rates investment. In this light, the goal of returning private capital to the mortgage market can be thought of as two separate problems.

1. Return private capital to "Rates" investing in the private-label mortgage market

2. Return private capital to "Credit" investing in the GSE mortgage market.

Rates investing in the private-label market generally refers to the most senior or highest rated classes of private-label securities. While there was approximately $2 trillion of AAA bonds at the peak of the private-label market, representing about 20% of all mortgages, it is important to recognize that this may not have been as significant as it seems. A substantial portion of these bonds were held by Fannie Mae, Freddie Mac and Home Loan Banks and thus were not truly private capital as the holdings were supported by issuance of GSE debt. In addition, a significant portion of the private-label senior bonds were floating rate notes and therefore did not support fixed-rate mortgages.

Given the tremendous regulatory uncertainty surrounding private-label securitization, it is not likely that there will be significant growth in this sector in the near future, nor is it likely that this sector would provide a stable source of financing for the bulk of the mortgage market under even the best of circumstances. Past history indicates that in times of stress this market significantly underperforms the guaranteed market for Rates investments.

Private Capital for the GSE market

For the remainder of this statement, I will concentrate on the second flow: returning private capital to Credit investing in the GSE market and the institutional structures necessary to support those flows. To begin this discussion it is useful to understand the amount of capital that is required to bear the credit risk of the GSE market. There are currently about $10 trillion dollars of mortgages outstanding. Fannie Mae and Freddie Mac currently bear the credit risk of almost 50% of those loans and issue about $1 trillion of new mortgage commitments each year. One simple way of assessing the amount of capital needed is to look at bank capital

requirements. If these loans were held by insured depositories, risk-based capital would be about 4%. The current portfolio of loans would require capital of about $200 billion. On an annual basis, the GSE guarantees would be generating about $40 billion of capital requirement at the 4% level. Because this amount is less than the several hundred billion dollars of capital that currently bears the credit risk of the legacy private-label mortgages, it is highly likely that capital could be attracted to this market given the right mechanisms and the appropriate pricing.

Prior to conservatorship, GSEs shareholders bore this credit risk. However, the GSEs were only required to hold 45 basis points or 0.45% minimum capital for their off balance sheet credit exposure. If the GSEs had been required to hold more capital or forced to take on less risk, they would not have depleted their capital. Yet the nature of the GSEs was to continually insist that they were over capitalized and any required increase in capital was called a "tax on homeownership." It retrospect, it is clear that insufficient capital resulted in a severe burden for taxpayers. Due to this experience, taxpayers are reluctant to support a system that recapitalizes the GSEs under their pre-crisis structure.

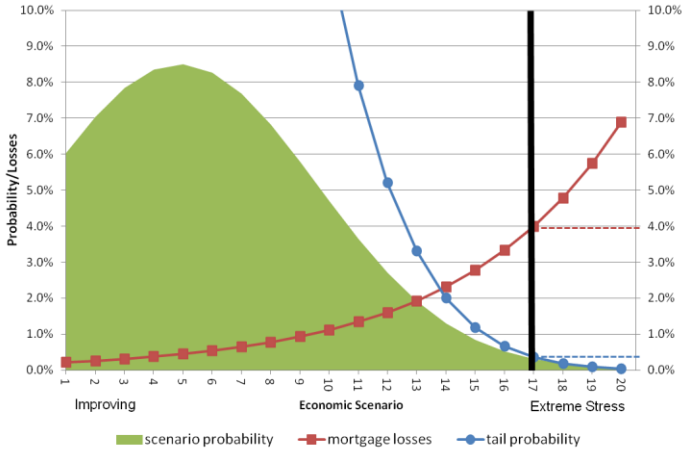
Determining the Amount of Capital?

When private capital is used to protect the government from losses, the risk to the taxpayer decreases as the quality of the loans increases and as the amount of private capital increases. Because the risk to the government guarantor decreases as the amount of private capital increases, it is important to set appropriate levels of credit enhancement. A framework for assessing the amount of capital required is to assess the amount of loss at different levels of probability or under different stress scenarios. The figure below illustrates these relationships. The red line shows the losses on a pool of mortgages under increasing stress scenarios. The

green area shows the probability of those scenarios. The blue line is the sum of the probabilities for each scenario combined with the probability of the scenarios with higher losses than that scenario. This chart indicates that credit enhancement of 4% would provide protection for 99.5% of all scenarios. In the most adverse scenario shown in the chart the government would pay 3% of the loan amount. Modest wrap fees would cover those losses over long cycles as the probability of loss is very low. A wrap fee of 3 basis points per year would be more than adequate to cover the loss. (3% loss x 0.5% probability = 0.15% lifetime loss, and 0.15% life time loss divided by 5-year life = 0.03% or 3 basis points per year.)

Risk of Loan Loss and Required Credit Enhancement

Higher subordination reduces the risk of triggering government guarantee.



Another way to assess the amount of credit enhancement required is to look at the historical performance of the loans guaranteed by Fannie Mae and Freddie Mac. It is noteworthy that the GSEs combined draw on the Treasury was under $200 billion. This amount represents less than 4% of their combined guarantee portfolio. In addition, many of the losses were from low or no documentation loans that should either be severely constrained or prohibited in guaranteed MBS.

Freddie Mac recently released detailed loan level credit performance data on its fully-documented, fully-amortizing, 30-year, fixed-rate mortgages. The performance of these loans through the crisis should provide an indication of the amount of credit enhancement required to protect a government guarantor from losses. This data was summarized in a report by Laurie Goodman of Amherst Securities.[1] The 2007 cohort of loans has the worst performance and experienced an 11.2% default rate, when measured as 180 days delinquent. (Assuming a 30% severity, that would translate into a 3.3% loss, at 40% severity, a 4.4% loss.) In addition, Goodman shows that there is significant variation on default rates by FICO and LTV characteristics.

Any guarantee program will need to establish a range of acceptable loan characteristics for guaranteed securities and an appropriate level of credit enhancement based upon the characteristics of the loans. Even after a range of allowable loan characteristics is determined, disciplined underwriting processes are required, particularly in securitization where the origination and underwriting processes are separated from the investment function.

It is essential to have contractual mechanisms to ensure that the underwriters have properly assessed the quality of the underwriting information and are held responsible for the accuracy of the information they provide. In that respect, the current representation and warranty process is flawed both in concept and in execution. In general, it would be better to move from a process that leads to enforcement of representations and warranties upon default to one that focuses on validation at the inception of the loan. In addition, a set of penalties for delivering flawed loans would be more effective than the current method of repurchase requests.

[1] Laurie Goodman et al, Amherst Mortgage Insight, "A First Look at Freddie's New Loan Level Credit Performance Data, March 25, 2013.

What is the Cost?

Private capital comes at a cost, as private investors demand returns commensurate with the level of risk they bear. Andrew Davidson & Co. has performed several analyses of the cost of private capital, including a study for the Bipartisian Policy Center's Housing Commission.[2] In our report we stated:

> Credit costs vary significantly based on borrower credit scores (FICO) and LTV ratios. For example, the credit cost for loans with FICO greater than 750 and LTV below 80% would be less than 25 basis points a year, while the credit cost for loans with FICO below 700 and LTV greater than 90% would be more than 10 times higher and exceed 250 basis points a year. Policy decisions to widen or narrow the "credit box" could have a great impact on the required Annual Credit Cost). The results here assume modest home price appreciation in the base case, consistent with long term income growth. However, during periods of falling home prices or greater market uncertainty, the market price for credit guarantees would be higher.

Using similar methods we found that the annual credit cost associated with the loans currently originated by the Freddie Mac would be about 30 to 35 basis points and that subordination levels of 6% would protect the government guarantor from losses at the 0.5% probability level. In addition to the annual credit cost of 30 to 35 basis points there would be additional operational costs of perhaps 6 to 8 basis points. The government guarantor should also charge a fee for its wrap. If that fee were 5 to 10 basis points, the overall required guarantee fee would be 41 to 53 basis points. Such a level is higher than the guarantee fees that the GSEs charged historically, but consistent with their current level.

Preserving the TBA market

While seeking to bring in new capital and new forms of capital to reduce the risk to taxpayers from future losses on mortgages, it is important that the new structures do not interfere

[2] http://bipartisanpolicy.org/library/research/modeling-impact-housing-finance-reform-mortgage-rates

the market's ability to attract Rates investors to provide for the trillions of dollars of funding currently provided by GSE mortgage backed securities. An important component of the tremendous success in attracting Rates investors to GSE MBS is the TBA market. This was the subject of another hearing of this committee on August 3, 2011.[3] At that hearing I said that the success of the TBA market was related to four factors.

1. Government Guarantee
2. Standardization of Loans/Pools from GSEs
3. Market Standards from SIFMA
4. Confidence arising from long history of market development

Changes to the TBA market affecting any of these could be detrimental to the liquidity and success of the market. In particular, I believe that proposals that allow multiple issuers of mortgage backed securities and eliminate the government guarantee are unlikely to attract the necessary volume of Rates investors to the TBA market. Such approaches could result in severe disruptions to funding for mortgages during periods of stress. Even proposals that maintain the government guarantee but substantially alter the functioning of the TBA market my not produce a stable, liquid market.

Corporate Guarantees and Collateralized Credit Enhancement

As part of any GSE reform, I believe Congress should continue the use of a government guarantee to support the trading of MBS, but should shield taxpayers from the risk of credit

[3] Statement of Andrew Davidson, US Senate Banking Committee, "Examining the Housing Finance System: The To-Be-Announced Market," August 3, 2011

losses by utilizing private capital to bear the credit risk of the underlying loans.[4] Generally this credit enhancement can be provided either as a corporate guarantee based upon the capital of the entity providing the guarantee or as a collateralized credit enhancement with performance supported by specific assets or cash.[5] Examples of corporate guarantees are the GSE credit guarantees on MBS and MI guarantees. These guarantees depend primarily on the financial capacity of the insurer as the payment for the guarantee comes from corporate funds.

Examples of collateralized credit enhancement include senior/subordinated structures and credit-linked notes. This form of credit enhancement, which is also sometimes called "funded" credit enhancement, depends primarily on the performance of the underlying loans relative to the amount of credit enhancement. The full amount of potential losses to the guarantor is funded in advance; excess cash flow not required to cover losses is returned to the investor over time. Interestingly, Home Loan Bank advances, one of the most stable sources of funding through the financial crisis, benefited from both corporate guarantees and collateralization.

The corporate guarantee approach offers the benefit that there can be flexible utilization of capital to cover many potential risks. It is also frequently argued that if the corporate guarantee is from a monoline company, there will be a continuous supply of capital to the market since the capital cannot be redeployed to other markets. Corporate guarantees also allow for very flexible contracts and the potential for renegotiation contracts in periods of stress.

[4] In February 2012, Andrew Davidson & Co. sponsored a round table discussion on the use of risk sharing for the GSEs. A summary of the meeting can be found at: http://www.ad-co.com/analytics_docs/GSE_CreditSharingRoundtable_Summary.pdf

[5] In a speech this past Thursday to the Federal Reserve Bank of Chicago Bank Structure Conference, FHFA Director Ed DeMarco discussed similar concepts in describing an "Issuer Based Approach" and a "Securities Based Approach" to utilizing private capital.

Collateralized credit enhancement offers the benefit that there is no need to monitor the viability of the company providing the guarantee to assess the strength of the guarantee. The strength of the guarantee is determined completely by the amount of excess collateral or cash supporting the guarantee. Given the difficulty of monitoring corporate balance sheets, it is surprising that most regulation of guarantees in the financial sector has been in the form of corporate guarantees: both the FDIC and FHFA monitor the adequacy of the regulated firms' capital to cover the risk.

Both corporate guarantees and collateralized credit enhancement can be securitized and transferred to different owners. The securitized form of corporate guarantees is the equity of the guarantor. Such equity, however, provides little transparency into the value of the guarantees. During periods of stress, it may be extremely difficult for the company to raise new equity as the uncertain value of the existing obligations taint the new business. The securitized form of collateralized credit enhancement is a bond that can be traded. This facilitates liquidity and transparency, even in distressed markets, as new investment is clearly separated from prior distressed bonds.

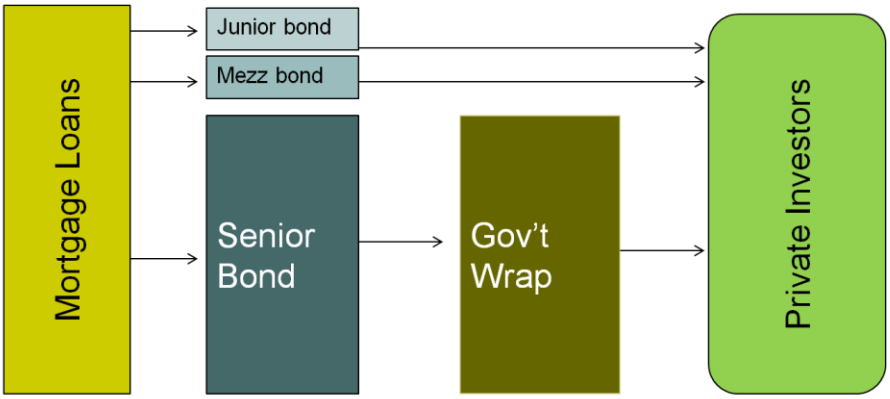
The two structures also have tradeoffs in terms of cost. Corporate guarantees allow the guarantor to spread capital over multiple obligations and maintain control of their assets. These guarantees, however, are usually backed by high-cost equity. The investor in a collateralized credit enhancement security does not have control of the assets used as collateral and often those assets can be invested in only high-quality assets with lower returns. Collateralized credit enhancement, however, can be structured into bonds of varying credit risk and therefore allow lower cost pricing of the lower risk portions of the support. Despite these differences, in theory, similar levels of support should have similar cost. In practice, regulation can create very

different levels of support (and therefore cost) as was the case with the unreasonably low capital requirement for the GSEs.

Collateralized Credit Enhancement: Senior/Subordinate and Credit-Linked Notes

Senior/Subordinated Structures and Credit-Linked Notes have been discussed as mechanisms to deliver private capital to bear the credit risk of GSE MBS. From a broad economic perspective the two are very similar. However, due to substantially different regulatory treatment, there is substantial difference in their implementation. The main differences between these, and other similar structures, are related to operational, legal, tax and accounting issues. All securitization transactions represent a particular pathway through a thicket of regulations. In the case of the GSE private capital transactions, the thicket has been difficult to navigate.

Schematic of a Senior/Subordinated Transaction with Government Wrapped Senior Bond



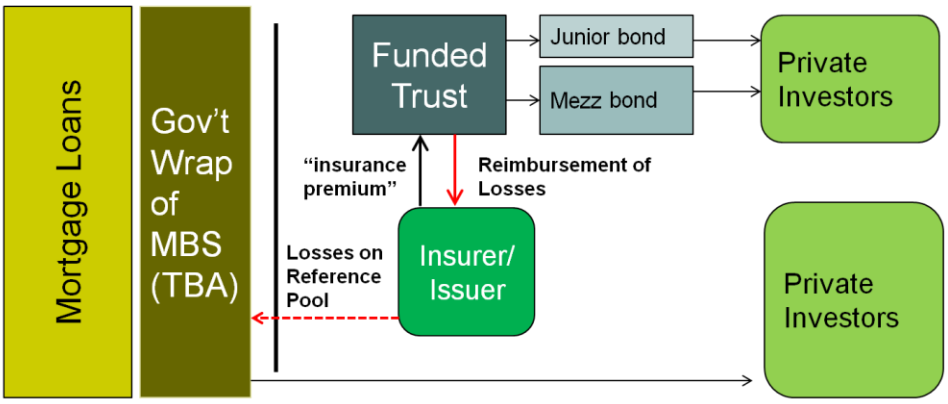
"Insured" loss amount is fully funded by the subordinate securities

For example, senior subordinated structures allow investment by a wide range of firms and are protected from taxation at the trust level by REMIC rules. However, the use of

senior/subordinate transactions by the GSEs would require a significant change in the operation of the GSEs. Under current rules, the GSEs cannot issue senior/subordinate transactions directly and instead they provide guarantees on privately issued transactions. These transactions require SEC registration and those registration requirements are not consistent with the operation of the TBA market. Subordination based solutions are also likely to introduce additional heterogeneity into mortgage backed securities issuance.

On the other hand, credit-linked notes would allow the GSEs to continue the current operation of their MBS programs, and hence the TBA market with little or no change. However the bonds would not be considered Real Estate Related Investments for REITs and there are other detrimental tax consequences since these transactions do not qualify as REMICs. In addition, Credit-Linked Note transactions generally require an entity to manage credit risk, as they essentially re-insure credit risk rather than bear credit risk directly.

Schematic of a Credit-Linked Note



Credit Linked Notes do not alter cash flows of MBS

Obstacles to Implementation

My understanding is that the GSEs and FHFA are pursuing a variety of approaches and variants on these approaches, including indexed debt, to address as many of these concerns as possible. The path to bringing these transactions to market has been delayed due to the complexity of the regulations governing these types of transactions and the different regulatory treatment of transactions with very similar economics.

Capital markets solutions will generally be most effective if they allow the broadest range of investors for both the senior guaranteed securities and for the junior credit sensitive securities. Protection from double taxation, exemption from securities registration especially for the senior notes (to facilitate the TBA market), allowing REIT investment from both SEC and tax perspectives and conforming risk retention rules are necessary components for an effective risk sharing program. The role of CFTC oversight, and CFPB QM requirements should also be addressed.

Clear, consistent rules would increase liquidity and lower the cost of these transactions. They would also allow the GSEs and FHFA to focus on the operational and economic aspects of these transactions rather than conflicting regulatory requirements.

Addressing the regulatory issues would not negate the investors' need for appropriate loan level disclosure and assurances as to underwriting quality and servicing practices including loss mitigation and enforcement of violations of representations and warranties. However, it is possible that investors would require less direct involvement with a well run standardized process from the GSEs than they would from other private issuers. FHFA oversight might provide the needed protection for investors.

Just as Home Loan Bank advances use a blend of corporate guarantees and collateralization, the private capital bearing the credit risk of the GSE MBS does not need to be limited to one type of credit enhancement. Corporate guarantees and collateralized credit enhancement could work hand in hand. For example, even with the use of credit-linked notes it may make sense to continue the use of mortgage insurance. Loan-by-loan mortgage insurance can reduce the risk of default and lower losses, therefore mortgage insurance can reduce the amount of required funded credit enhancement. In addition, it may make sense to encourage firms focused on mortgage investments, like REITs and Mortgage Insurance companies, to provide capital through collateralized mechanisms such as credit-linked notes, thus gaining the benefits of permanent capital and the transferability of securitized guarantees.

Industrial Organization of Housing Finance

The use of securitized collateralized guarantees such as subordinated bonds and credit-linked notes will lower the risk to the tax payer from government guarantees of MBS. However, the stability of the mortgage finance and many other goals associated with government involvement in the mortgage market depend more on the industrial organization of the mortgage market than the form of credit enhancement. The success of any system of housing finance will also depend critically on the path from the current structure of the housing finance system to the desired future structure.

On one hand, there appears to be a broad consensus developing that homeowners seeking mortgage financing would be best served by a system that allows for mortgage-backed securities with an explicit government wrap and with private capital standing in front of the government wrap for some segment of homeowners. On the other hand, there is little consensus about the

nature of the entities that would provide the private capital and the role of the government in providing standards and regulating the suppliers of private capital. One possible solution is to use "cooperatives."

A Cooperative Solution

On balance, I believe that cooperatives will provide the best possible structure to deliver private capital to the mortgage market and promote stability. When Freddie Mac was established, it was owned by the Federal Home Loan Banks which in turn were owned by the Savings and Loans. Thus, Freddie Mac began its life as a cooperative whose goal was to enable its members to access the securitization market. Utilizing cooperatives as a replacement for the publically owned GSEs would return the market to this structure. The Home Loan Bank System survived the crisis without the need for a capital infusion from the government. In fact, as I will describe below, the Home Loan Banks were a source of liquidity for the mortgage market during the crisis. Another example of a successful cooperative is DTCC. DTCC provides clearing services for bond trading and many other markets and has mechanisms that ensure that its members are appropriately collateralizing their transactions.

Securitization cooperatives should establish standards for securitization and promote risk sharing, to ensure that the risks of the securitized mortgages are transferred to the capital markets. At the same time, the cooperative must ensure that there is appropriate disclosure of risks and quality assurance that securitized loans meet underwriting standards. Another important consideration is the ability of the securitization infrastructure of mortgage finance to survive a financial crisis.

In light of these considerations, there should be a two tiered structure for the cooperatives. In the first tier, originators would form a cooperative that would set standards for mortgage originations and securitization. This tier would also own and control the mortgage securitization infrastructure. This approach is similar to the FHFA securitization infrastructure project which recognizes the need for operational consistency and stability in the market that is distinct from the risk bearing function.

In the second tier, firms that have loans to securitize would sell loans to the cooperative and provide some amount of equity funding that would serve as risk retention. The loans would be pooled and sold into the market. The government would provide a wrap on the mortgage backed securities and the cooperative would retain a portion of the first loss obligations on securities. The cooperative would also utilize collateralized credit enhancement transactions such as credit-linked notes and subordinated bonds to sell a significant portion of the credit risk into the market. Bucketing and insuring loans by vintage will make clear what risks are assumed by the cooperative and what risks are assumed by the government guarantor. Rather than insisting that the cooperatives fail or enter conservatorship before the government guarantee is triggered, it would be better if the government guarantee were triggered when the collateral and credit enhancement associated with a particular vintage are exhausted. Such an approach would provide a much greater level of stability to the financial system. Any difference in risk to the government guarantor could be reflected in the amount of credit enhancement required and the pricing of the government wrap.

Cooperatives also generally are less innovative than ordinary corporations but are generally more innovative than government entities. While the middle position may be a virtue in many situations, there may be difficulties in periods where more or less innovation is required.

Generally the most significant challenge of cooperatives is maintaining an effective governance mechanism when its members have differing goals. To this end, regulation and oversight will be required to ensure adequacy of capital and access to all qualified participants.

Regulation of the Cooperatives

As the cooperatives would be in a central position in the mortgage industry there would be multiple dimensions of government regulation. For example, the CFPB would be concerned with the underwriting, servicing, and disclosure rules as they relate to borrowers. As guarantor, the government would be concerned about the credit quality of the loans that are originated and the adequacy of capital supporting the first loss position. As securities regulators, the government would be concerned about the appropriate disclosure of risk to investors and coordinate disclosure requirements with Securities and Exchange Commission rules, even if these entities were not subject to full registration requirements. In addition, Treasury and the Federal Reserve System would want to monitor systemic risk associated with concentrated or undisclosed risk from mortgage securitization.

Number of Cooperatives

Because of the complexity of regulating the cooperatives, I believe it would be preferable to have fewer cooperatives. Two or three would probably be the ideal number; some have argued for one.[6] In the private-label market, we found that multiple issuers can lead to a "race to the bottom," as investors found it difficult to assess the constantly varying deal structures from multiple issuers. The alternative to a few cooperatives would be a much more invasive

[6] Toni Dechario, Patricia Mosser, Joseph Tracy, James Vickery, and Joshua Wright, "A Private Lender Cooperative Model for Residential Mortgage Finance," *Federal Reserve Bank of New York Staff Reports*, no. 466, August 2010 http://www.newyorkfed.org/research/staff_reports/sr466.pdf

regulatory scheme to establish standards. Such government standards would likely be subject to political manipulation and insufficient innovation. The FHFA common infrastructure project appears to be based upon the idea that, at least for the central plumbing of the market, proliferation of issuers with different approaches to mortgage securitization is not desirable. Time will tell whether or not the government-led infrastructure project will achieve its goals.

Many issuer based proposals favor a large number of issuers so as to allow one or more to fail without threatening the viability of the system. Fewer cooperatives would not pose the same risk to the financial system because the risk bearing function would be separate from the operational component, and the use of risk sharing transactions could substantially reduce the risk of insolvency. Fewer cooperatives would substantially reduce the cost of monitoring capital adequacy, as a large number of issuers would require a significant regulatory structure to monitor the activities of each entity.

A Stable Housing Finance System that Serves the Needs of all Constituencies

The combination of securitization cooperatives, collateralized credit enhancement and a government wrap of high quality MBS will enable the housing finance system to function effectively for borrowers, originators, investors and taxpayers.

For borrowers, this system allows the continuation of fixed-rate lending at a reasonable cost. High risk borrowers, such as high-LTV, first-time homebuyers, would probably still need to utilize FHA guaranteed lending. High income borrowers and borrowers seeking specialized types of loans could be served outside the government supported programs. The cooperatives would set market standards subject to government review, thus allowing standardization of loan underwriting requirements and servicing rules, thus providing protections to borrowers from

unfair practices. In addition, if there were any excess profits that result from a centralized credit function, those profits would feed back into the mortgage finance system rather than being captured by the private shareholders as we experienced with Fannie Mae and Freddie Mac.

For originators, cooperatives would provide a mechanism for all firms to participate in securitization, as the government can monitor membership requirements. Cooperatives would also provide a mechanism for risk retention, while still allowing sale treatment for originators. Under many other proposals, securitization risk retention requirements might require consolidation of securitizations on the issuers' balance sheet. While the cooperative would likely need to consolidate the securitizations, the originating firms would only show their equity investment in the cooperative on their balance sheet.

For investors, the structure described here would allow the continued functioning of the TBA market that has been so attractive to Rates investors. In addition the use of credit-linked notes and other risk sharing transactions would create a new market for Credit investors. The high quality loans and clear standards of the cooperative would create a market where investors could focus on the investment risks rather than the difficulty of complex and inconsistent offering documents and divergent servicing practices.

Taxpayers will be protected from loss by multiple levels of requirements. Clear underwriting standards describing what is allowed in guaranteed pools would be the first line of defense. Properly capitalized and non-rescindable mortgage insurance could be used to expand the credit box to include lower down-payment loans without subjecting the taxpayer to excessive risk. Cooperatives would be particularly effective at insuring that representations and warranties are enforced as the members would be on the hook for violations and the members are in the best

position to assess poor practices of other originators. Taxpayers would also be protected by equity provided by cooperative members associated with their use of securitization. Finally risk sharing transactions such as credit-linked notes will bring in a substantial amount of capital to stand in front of the government guarantee.

Liquidity and Stability

Perhaps most importantly, a system which combines a government guarantee on MBS, with a cooperative that can utilize capital markets funding of credit risk has a great potential for operating through a financial crisis. As an example, the Home Loan Bank System provided liquidity to the mortgage market by combining access to debt capital markets with borrower overcollateralization. Ashcraft, Bech, and Frame[7] wrote:

> During the second half of 2007, the FHLB System increased its advance lending by $235 billion to $875 billion by the end of that year. Advances have continued to grow into 2008, albeit at a slower rate, and stood at $914 billion as of June 30, 2008.

As firms utilized the FHLB system they provided additional equity and collateral to support their lending. Similarly, securitization cooperatives would allow originators to provide more capital to the cooperative to meet credit support requirements during stress periods, rather than the guarantor relying on new offerings in the stock market. The securitization structures would allow distress focused investors to take advantage of leverage provided by government guarantee by purchasing new risk sharing bonds. In fact, as a result of a flight to quality, the tightening of spreads (higher prices) on the government guaranteed MBS by Rates investors during a crisis, might offset the wider spreads (lower prices) required by Credit investors.

[7] Adam B. Ashcraft, Morten L. Bech, and W. Scott Frame, **"**The Federal Home Loan Bank System: The Lender of Next-to-Last Resort?" *Federal Reserve Bank of New York Staff Reports*, no. 357**,** November 2008. http://www.newyorkfed.org/research/staff_reports/sr357.pdf

Transition to Cooperatives

There is a relatively straight forward transition from today's market to a cooperative based system. A system for administering the government wrap would need to be established, but could probably be built upon the current foundation at GNMA. Fannie Mae and Freddie Mac could be transformed into cooperatives, first by stripping out the unnecessary and unwanted functions, such as the retained portfolios, and by lowering loan limits and limiting loan types. Fannie Mae and Freddie Mac could also utilize risk sharing transactions to reduce their risk exposure. The stripped down entities could then be sold to qualified cooperatives that would be subject to appropriate levels of regulation.

With the appropriate government guarantee in place, the TBA market could continue unchanged through the transition of the GSEs from conservatorship to cooperative ownership. Most other GSE reform and housing finance proposals do not offer such a clear path from here to there.

Conclusion

The current GSE MBS market provides trillions of dollars of financing to the mortgage market. Government Guarantees and other structural features are required to maintain this market. Collateralized Guarantees in the form of credit-linked notes can be used to reduce the risk to taxpayers from government provided guarantees on MBS. Securitization cooperatives may be the best form of organization to deliver standardization and risk sharing. The existing GSEs could be transformed into originator-owned cooperatives with little disruption to the mortgage finance system.

I would like to thank the committee for giving me this opportunity to express my views on returning private capital to the mortgage markets. I have been involved with Mortgage-Backed Securities (MBS) since 1985. I was a managing director at Merrill Lynch responsible for MBS research and risk management for their mortgage trading desk. In 1992, I founded Andrew Davidson & Co., a New York based firm, specializing in the development and application of analytical tools for the MBS market that serves over 150 financial institutions. I have a broad view of housing finance as our clients include originators, servicers, mortgage insurers, GSEs, investors, dealers and regulators. I am also on the executive committee of the newly formed Structured Finance Industry Group (SFIG) which is dedicated to maintaining the role of structured finance and securitization as a core form of financing for the economy. The opinions in this statement are my own.