SECURITIZATION OF ASSETS: PROBLEMS AND SOLUTIONS

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ON
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# C O N T E N T S

**WEDNESDAY, OCTOBER 7, 2009**

<table>
<thead>
<tr>
<th>Opening statement of Chairman Reed</th>
<th>1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepared statement</td>
<td>30</td>
</tr>
</tbody>
</table>

Opening statements, comments, or prepared statements of:

<table>
<thead>
<tr>
<th>Senator Bunning</th>
<th>2</th>
</tr>
</thead>
</table>

## WITNESSES

<table>
<thead>
<tr>
<th>Patricia A. McCoy, George J. and Helen M. England Professor of Law, and Director, Insurance Law Center, University of Connecticut School of Law</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepared statement</td>
<td>30</td>
</tr>
<tr>
<td>George P. Miller, Executive Director, American Securitization Forum</td>
<td>5</td>
</tr>
<tr>
<td>Prepared statement</td>
<td>41</td>
</tr>
<tr>
<td>Andrew Davidson, President, Andrew Davidson and Company</td>
<td>7</td>
</tr>
<tr>
<td>Prepared statement</td>
<td>51</td>
</tr>
<tr>
<td>J. Christopher Hoeffel, Executive Committee Member, Commercial Mortgage Securities Association</td>
<td>8</td>
</tr>
<tr>
<td>Prepared statement</td>
<td>62</td>
</tr>
<tr>
<td>William W. Irving, Portfolio Manager, Fidelity Investments</td>
<td>10</td>
</tr>
<tr>
<td>Prepared statement</td>
<td>69</td>
</tr>
</tbody>
</table>

## ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

| Statement submitted by the Mortgage Bankers Association | 74 |

(III)
SECURITIZATION OF ASSETS: PROBLEMS AND SOLUTIONS

WEDNESDAY, OCTOBER 7, 2009

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 2:35 p.m. in room SD–538, Dirksen Senate Office Building, Senator Jack Reed (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman Reed. The Committee will come to order. I want to welcome everyone and particularly thank our witnesses for making themselves available today.

This hearing will examine a key activity within our financial markets—the securitization of mortgages and other assets—and will build on previous hearings this Subcommittee has held to address various aspects of regulatory modernization, including hedge funds, derivatives, corporate governance, SEC enforcement, and risk management at large financial institutions.

Securitization is the packaging of individual loans or other debt instruments into marketable securities to be purchased by investors. At its core this process helps free lenders to make more loans available for families to purchase items like homes and cars and for small businesses to thrive.

But we have learned from the financial crisis that securitization or how it is conducted can also be extremely harmful to the financial markets and families without appropriate diligence and oversight. Arguably, many of the basic requirements needed for effective securitization were not met over the course of the last several years.

Today’s panel will discuss how in recent years the securitization process created incentives throughout the chain of participants to emphasize loan volume over loan quality, contributing to the build-up and collapse of the subprime mortgage market and the broader economy.

Today we find ourselves in the opposite position from a few years back with hardly any issuances in key markets that could help return lending to responsible levels. So this afternoon’s hearing is about how to strengthen the securitization markets and enact any needed changes to ensure that securitization can be used in ways
that expand credit without harming consumers and the capital markets.

I have asked today’s witnesses to address a number of key issues, including the role securitization played in the financial crisis, the current conditions of these markets, and what changes may be needed for Federal oversight of the securitization process.

Unfortunately, a number of the banks who issue these securities could not find anyone in their workforce who was willing to testify today, but we are lucky to have experts here, both academic and business experts. I welcome you all and look forward to your testimony.

Let me now turn it over to Senator Bunning for his remarks.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

All it takes is a short amount of time studying the market for asset-backed securities to realize really how complicated it is. Right now there is no basic private securitization market, especially for mortgages. I hope this hearing will help us all get a better understanding of the market and what we can do and should be done to make it work better.

In theory, securitization is a great idea that brings more capital to the financial markets, leading to more loans for individuals and businesses. Done properly, that is a good thing. But as we saw last year, if it is done wrong, it can lead to disaster.

The natural first question is whether the problems we saw were a result of a bad theory or bad execution. For several reasons, I think what happened was bad execution as a result of other bad policies and regulations.

Probably the biggest factor that led to the problems in the securitization market were artificial demand created by bank capital rules favoring highly rated securities over whole loans. That artificial demand found a home in residential mortgage securities thanks to the GSEs’ loose underwriting and easy money. And the rating agencies enabled it all. We should start by fixing those problems.

Once the bad incentives and artificial demand are taken away, real risk analysis can be done, and price can be based on real value. The Government will not have to solve all the problems because investors will demand more protections from the issuers.

For example, the model where issuers were paid by the number of deals closed and loan originators passed on all responsibility and collects profits up front will not be tolerated by investors in the future. That will lead to a solution tailored to a particular asset and flexible enough to be changed as the market evolves.

I hope our witnesses will comment on these ideas and provide some of their own, because we really need them.

Thank you.

Chairman REED. Thank you, Senator Bunning, and I would welcome any comments by my colleagues Senator Corker or Senator Gregg.

[No response.]

Chairman REED. Thank you very much. Now let me introduce our witnesses.
Our first witness is Professor Patricia A. McCoy, the Director of the Insurance Law Center and the George J. and Helen M. England Professor of Law at the University of Connecticut Law School. Professor McCoy specializes in financial services law and market conduct regulation. Prior to her current role, Professor McCoy was a partner in the law firm of Mayer Brown in Washington, DC, and specialized in complex financial services and commercial litigation. Thank you, Professor McCoy.

Our next witness is Mr. George P. Miller. Mr. Miller is the Executive Director of the American Securitization Forum, an association representing securitization market participants including insurers, investors, and rating agencies. Mr. Miller previously served as Deputy General Counsel of the Bond Market Association, now SIFMA, where he was responsible for securitization market advocacy initiatives. Prior to that, he was an attorney in the corporate department at Sidley, Austin, Brown & Wood, where he specialized in structured financial transactions, representing both issuers and underwriters of mortgage and asset-backed securities. Thank you, Mr. Miller.

Mr. Andrew Davidson is the President of Andrew Davidson & Company, a New York firm which he founded in 1992 to specialize in the application of analytical tools to mortgage-backed securities. He is also a former managing director in charge of mortgage research at Merrill Lynch.

Mr. Christopher Hoeffel is an Executive Committee member of the Commercial Mortgage Securities Association, the trade association representing the commercial real estate capital market finance industry. Mr. Hoeffel is also the Managing Director of the investment management firm Investcorp International, responsible for sourcing, structuring, financing, underwriting, and closing new debt investments for the group. Mr. Hoeffel joined Investcorp from JPMorgan Bear Sterns where he was a senior managing director and global cohead of commercial mortgages.

Our final witness is Dr. William Irving, a portfolio manager for Fidelity Investments. Dr. Irving manages a number of Fidelity’s funds, including its mortgage-backed security Central Fund, Government Income Fund, and Ginnie Mae Fund. Prior to joining Fidelity, Dr. Irving was a senior member of the technical staff at Alpha Tech in Burlington, Massachusetts, from 1995 to 1999 and was a member of the technical staff at MIT Lincoln Laboratory in Lexington, Massachusetts, from 1987 to 1995.

Welcome, all of you. Professor McCoy, would you please begin?

STATEMENT OF PATRICIA A. MCCOY, GEORGE J. AND HELEN M. ENGLAND PROFESSOR OF LAW, AND DIRECTOR, INSURANCE LAW CENTER, UNIVERSITY OF CONNECTICUT SCHOOL OF LAW

Ms. McCoy, Thank you. Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee, thank you for inviting me here today.

In the run-up to the crisis, Wall Street financed over half of subprime mortgages through private label securitization. When defaults spiked on those loans and housing prices fell, securitization collapsed in August 2007. It has been on life support ever since.
When private label securitization comes back, it is critical to put it on sound footing so that it does not bring down the financial system again. The private label system had basic flaws that fueled the crisis.

First, under the originate-to-distribute model, lenders made loans for immediate sale to investors. In addition, lenders made their money on up-front fees. Both features encouraged lenders to “pass the trash.” Lenders cared less about underwriting because they knew that investors would bear the brunt if the loans went belly up. In addition, to boost volume and fees, lenders made loans to weaker and weaker borrowers. In fact, when I have examined the internal records of some of the largest nonprime lenders in the United States, I have often found two sets of underwriting standards: lower standards for securitized loans and higher ones for loans held in portfolio.

Second, securitizations spread contagion by allowing the same bad loan to serve as collateral for a mortgage-backed security, a collateralized debt obligation, and even the CDO of CDOs. It further spread contagion because investors used tainted subprime bonds as collateral for other types of credit, such as commercial paper and interbank loans. This shook confidence in the entire financial system because investors did not know where the toxic assets were located.

Last, securitization resulted in a servicing system that creates thorny barriers to constructive workouts of distressed loans. We have had too many foreclosures as a result. In this, there were three victims: borrowers, who were steered into bafflingly risky mortgages, often at inflated interest rates; investors, who were forced to rely on ratings because securities disclosures were deficient and securitizations were so complex; and, finally, the public, who had to pay to clean up the mess.

So how do we fix these problems going forward? There are two aspects: lax underwriting and loan workouts.

First, fixing underwriting. One group of proposals seeks to realign incentives indirectly so that mortgage actors do careful underwriting. These include requiring securitizers to retain risk, higher capital requirements, better compensation methods, and stronger representations and warranties along with stiff recourse.

I applaud these measures, but they are not enough to ensure good underwriting. I doubt, for example, whether prohibiting issuers from hedging their retained risk is really enforceable. Banks are adept at evading capital standards, and the Basel II standards are badly frayed. And stronger reps and warranties are only as good as the issuer’s solvency. Consider the fact that most nonbank subprime lenders are out of business and 128 banks and thrifts have failed since the crisis began.

Another group of proposals focuses on better due diligence by investors and rating agency reform. This, too, is badly needed. However, memories of this crisis eventually will grow dim. When that happens, query whether investors will really take the time to do careful due diligence when a high-yield investment is dangled out in front of them.

For these reasons, we need to finish the work the Federal Reserve Board began last year and adopt uniform Federal under-
writing standards for mortgages that apply to all mortgage actors across the board. A brand-new study by researchers at UNC–Chapel Hill just found that States with similar laws had lower foreclosure rates than States without those laws. And a 2008 study found that State assignee liability laws did not reduce access to credit.

Then one last thought: facilitating loan workouts. Here I propose amending Federal tax laws to tax securitized trusts unless they provide ironclad incentives to do loan workouts when cost effective.

Thank you, and I welcome any questions.

Chairman REED. Thank you very much, Professor.

Mr. Miller, please.

STATEMENT OF GEORGE P. MILLER, EXECUTIVE DIRECTOR, AMERICAN SECURITIZATION FORUM

Mr. MILLER. Chairman Reed, Ranking Member Bunning, Members of the Subcommittee, on behalf of the American Securitization Forum, I appreciate the opportunity to testify today.

Securitization plays an essential role in the financial system and the broader U.S. economy. It is a mainstream source of credit and financing for individuals and businesses and finances a substantial portion of all consumer credit. Currently there is over $12 trillion of outstanding securitized assets, including mortgage-backed securities, asset-backed securities, and asset-backed commercial paper.

The size and scope of securitization activities reflects the benefits and value it has historically delivered to the financial system and economy. Restoration of greater function and confidence to this market is a particularly urgent need today, in light of capital and liquidity constraints currently confronting financial institutions and markets. With the process of bank de-leveraging and balance sheet reduction still underway, and with increased bank capital requirements on the horizon, it is clear that the credit and funding capacity provided by securitization cannot be replaced by deposit-based financing or other alternatives.

Simply put, the recovery and restoration of confidence in securitization is a necessary ingredient for economic growth to resume and for that growth to continue on a sustained basis into the future.

The U.S. securitization markets experienced substantial dislocation during the ongoing financial market turmoil. While there are signs of recovery in certain market sectors, others—most notably, private residential mortgage-backed securities—remain dormant, with other asset classes remaining significantly challenged.

Although tightened lending standards are one important reason for a broader constriction in the supply of credit, the impairment and reduction in securitization activity plays an equal, if not more important role.

Certain Government programs, including direct support for Government-guaranteed mortgage securitization and the TALF program for certain asset-backed securities, have been successful in supporting financing and the liquidity needs in part of this market. However, these programs are temporary, and a larger challenge remains to create a stable and sustainable private capital market platform for future securitization activity.
To accomplish this essential goal, a number of weaknesses and deficiencies of securitization revealed by the financial market crisis must be addressed. ASF and the broader industry are working actively to pursue and implement certain critical reforms, and we will continue to work constructively with policymakers on others. I would like to offer several overriding perspectives on these reform measures.

First, many of the problems that have been identified are not inherent in securitization per se. Instead, they relate to the manner in which securitization was used. As a general rule, the amount of risk inherent in a securitization transaction is equal to the risk that is embedded in the securitized assets themselves. However, ancillary practices and strategies, such as the excessive use of leverage and undue reliance on short-term funding for long-term liabilities, poor credit underwriting, or the absence of effective risk management controls, can amplify and concentrate these risks. This does not, however, mean that securitization itself is inherently flawed.

Second, any reform measures should be targeted carefully to address specific and clearly identified deficiencies. Equal care should be taken to consider the individual and combined effects of various policy reforms to ensure that they do not inadvertently stifle otherwise sound and desirable securitization activity. We are very concerned that some reform measures currently being pursued or under consideration—most particularly, the combined effect of accounting standards changes and proposed regulatory capital rules—are counterproductive policy responses that are not reasonably targeted to address identified problems. Such reforms may render it prohibitively expensive to securitize a wide range of consumer and business assets. In turn, this could blunt the ability of the financial system to originate and fund consumer and business credit demand that finances jobs and investments, just as the broader economy begins to recover. We believe that this is an important matter that would benefit from Congress's further attention.

Finally, from an industry perspective, ASF is focused primarily on devising and implementing concrete steps to improve the basic securitization market infrastructure in response to specific deficiencies identified in preexisting practices. Grouped broadly under the heading of “Project Restart,” these reforms will substantially improve and standardize information and data that is captured and reported to investors in securitized products, including, in the case of residential mortgage-backed securities, extensive and detailed loan level data. With these data enhancements broadly in place, securitization risks will be more transparent and capable of evaluation by investors and other market participants. At the same time, these data and standardization improvements will support higher-quality rating agency, due diligence, quality assurance, valuation, and other processes that depend on accurate and reliable underlying data.

And, finally, and briefly, another important goal of Project Restart is to enhance and standardize representations and warranties that originators of mortgage loans typically provide. Much like a defective product is returned to a store from which it was sold, a
mortgage loan that does not meet specified underwriting criteria should be returned to the originator through its removal from a securitization trust for cash. We believe that more effective representations and warranties will result in a full retention of economic risk by originators of defective loans consistent with the policy goal of requiring those who originate assets for securitization to retain a meaningful and continuing economic stake in the quality of those loans.

I thank the Subcommittee for the opportunity to testify today.

Chairman REED. Thank you very much.

Mr. Davidson, please.

STATEMENT OF ANDREW DAVIDSON, PRESIDENT, ANDREW DAVIDSON AND COMPANY

Mr. DAVIDSON. Good afternoon, Chairman Reed, Ranking Member Bunning, Members of the Subcommittee.

More than 2 years since the collapse of the Bear Stearns high-grade structured credit enhanced leverage fund, its name a virtual litany of woes, we are still in the midst of a wrenching economic crisis, brought on at least in part by the flawed structure of our securitization markets. I appreciate the opportunity to share my views on what regulatory and legislative actions could reduce the risk of such a future crisis.

I believe that securitization contributed to the current economic crisis in two ways:

First, poor underwriting led to unsustainably low mortgage payments and excessive leverage, especially in the subprime and Alt-A markets. This in turn contributed to the bubble and subsequent house price drop.

Second, the complexity and obfuscation of some structured products such as collateralized debt obligations caused massive losses and created uncertainty about the viability of key financial institutions.

Now to solutions. Boiled down to the essentials, I believe that for the securitization market to work effectively, bondholders must ensure that there is sufficient capital ahead of them to bear the first loss risks of underlying assets; that the information provided to them is correct; that the rights granted to them in securitization contracts are enforceable; that they fully understand the investment structures; and that any remaining risks they bear are within acceptable bounds.

If these conditions are not met, investors should refrain from participating in these markets. If bondholders act responsibly, leverage will be limited and capital providers will be more motivated to manage and monitor risks.

If this is the obligation of investors, what then should be the role of Government?

First, Government should encourage all investors and mandate that regulated investors exercise appropriate caution and diligence. To achieve this goal, regulators should reduce or eliminate their reliance on ratings. As an alternative to ratings, I believe regulators should place greater emphasis or reliance on analytical measures of risk, such as computations of expected loss and portfolio stress tests.
Second, Government should promote standardization and transparency in securitization markets. While the SEC, the ASF, and the rating agencies may all have a role in this process, I believe that transforming Fannie Mae and Freddie Mac into member-owned securitization utilities would be the best way to achieve this goal.

Third, Government can help eliminate fraud and misrepresentation. Licensing and bonding of mortgage brokers and lenders, along with establishing a clear mechanism for enforcing the rights of borrowers and investors for violations of legal and contractual obligations, would be beneficial to the securitization market. However, I believe that there are superior alternatives to the Administration’s recommendation of retention of 5 percent of credit risk to achieve this goal.

I would recommend an origination certificate that provides a direct guarantee of the obligations of the originator to the investors and the obligation of the originator to the borrowers coupled with penalties for violations even in good markets and requires evidence of financial backing. This would be a more effective solution.

If the flaws that led to the current crisis are addressed by Government and by industry, securitization can once again make valuable contributions to our economy.

I look forward to your questions. Thank you.

Chairman Reed. Thank you, Mr. Davidson.

Mr. Hoeffel, please.

STATEMENT OF J. CHRISTOPHER Hoeffel, EXECUTIVE COMMITTEE MEMBER, COMMERCIAL MORTGAGE SECURITIES ASSOCIATION

Mr. Hoeffel. Thank you. I am testifying today on behalf of the Commercial Mortgage Securities Association. CMSA represents the collective voice of all market participants in the commercial real estate capital market finance industry, including lenders, issuers, investors, rating agencies, and servicers, among others. These participants come together to facilitate a transparent primary and secondary market for commercial mortgages.

I am also an investor in CMBS, but I have more than two decades of experience as a commercial lender and a CMBS issuer. I would like to thank the Committee for the opportunity to share our views on securitization, which is crucial to borrower access to credit and our overall economy.

This afternoon, I will focus specifically on securitized credit markets for commercial real estate, focusing on three issues: first, the enormous challenges facing the $3.5 trillion market for commercial real estate finance, of which about $850 billion is securitized; second, the unique structure of CMBS and the need to customized regulatory reforms accordingly to support recovery; and, finally, the need to restore the CMBS market to meet significant borrower demand.

Today the commercial real estate market is facing a perfect storm based on three interconnected and pressing challenges. First, there is no liquidity or lending. In 2007, there were approximately $240 billion in CMBS loans made, approximately half of the total real estate lending market. CMBS issuance fell to only $12 billion
in 2008, despite strong credit performance at the time and high borrower demand. It has now been well over a year since a new CMBS deal has been done.

Second, there are significant loan maturities through 2010. In fact, hundreds of billions of dollars is coming due in the next 2 years. Capital refinance these loans is largely unavailable, and loan extensions are difficult to achieve.

Third, the downturn in the U.S. economy persists. Commercial real estate is greatly impacted by the macroeconomic factors: high unemployment, low consumer confidence, poor business performance, and falling property values. This last point is especially important to highlight. Remember, commercial real estate did not cause the current liquidity crisis. It has been negatively affected by it now, 2 years into the crisis. Second, even within the commercial real estate finance industry, CMBS or securitization did not cause stress. In fact, nonsecuritized loans are now underperforming CMBS and are experiencing in some cases greater defaults. Ironically, securitization may be ultimately an exit strategy for these troubled loans.

As financial policymakers, including the current and previous Administration, have rightfully pointed out, no recovery plan will be successful unless it helps restart the securitization markets. The IMF also asserts that securitization will assist withdrawal of Government interventions, employing private capital to fuel private lending.

Today many recovery efforts in the commercial real estate market, such as TALF and PPIP, have been helpful. But they are in a nascent and delicate stage, as discussed in my written testimony. So it is important that regulatory reforms, including accounting changes, as George mentioned, must work to strengthen the securitized markets and to give private investors who bring their own capital to the table certainty you and confidence.

Above all, in the commercial real estate context, there is a real concern that some of the reform proposals will be applied in a one-size-fits-all manner that could actually impede recovery. Specifically, there are a number of important distinctions between CMBS and other asset-based securities markets, and the upshot of these distinctions is that they help the CMBS market avoid problems of poor underwriting or inadequate transparency. These significant differences are in four major areas:

First, the borrower. In CMBS, the borrower in most cases is a sophisticated business within income-producing property and contractual revenues from tenants as opposed to some situations in the subprime residential mortgage where a loan may have been underwritten for a borrower who could not document his income.

Second, the structure of CMBS. There are only about 100 to 300 loans in a typical CMBS deal as opposed to thousands of loans in residential deals. This enables greater due diligence and analysis to be performed on CMBS pools by several different parties, including rating agencies and investors.

Third, the existence of a third-party investor or B-piece buyer in the securitization process. Unlike other asset classes, CMBS has an investor who purchases a first loss position and conducts extensive due diligence as a result, which includes sit visits to every prop-
erty. This investor also re-underwrites proposed loans in a potential pool, and they can negotiate to kick out any loans in which they do not wish to invest.

Finally, greater transparency. CMBS market participants have significant access to loan, property, and bond level information at issuance and on an ongoing basis. In fact, the CMSA investor reporting package is used as a model for transparencies by other types of ABS markets.

It is from this unique perspective that we approach regulatory reform proposals that will undoubtedly change the CMBS market. We do not necessarily oppose some of these proposals despite the fact that they will address practices that were typical in the subprime and residential securitization markets, not CMBS. Instead, we ask that policymakers ensure that such reforms are tailored to address the specific needs of each securitization asset class and to recognize the many safeguards that already exist in the CMBS market today.

In this regard, two aspects of regulatory reform are of utmost interest to CMSA: a requirement that securitizers—that is, bond issuers and underwriters—retain at least 5 percent of the credit risk in any securitized loan pool; and a restriction of the ability of issuers to protect against or hedge this 5-percent retained risk.

As is explained in more detail in my written testimony, the basic concern we have about both of these proposals is whether they will be applied in a one-size-fits-all manner. While we agree that it is important for the appropriate parties to keep skin in the game, CMBS deals are already structured to do this in a way that has worked well for the market and for the overall economy for years and can continue to serve the policy objective that is sought here.

As discussed earlier, first loss buyers conduct their own extensive credit analysis on the loans, examining detailed information concerning every property before buying the highest-risk bonds in the CMBS securitization. If these reforms are not applied in a tailored fashion, the danger is that the reforms will end up hampering the ability of CMBS lenders to originate new loans, thereby limiting capital and the flow of credit at a time when our economy desperately needs it.

Thank you.

Chairman Reed. Thank you very much.
Dr. Irving, please.

STATEMENT OF WILLIAM W. IRVING, PORTFOLIO MANAGER, FIDELITY INVESTMENTS

Mr. Irving. Good afternoon, Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee. Thank you for the opportunity to participate in today's panel.

I have a very simple three-part message that I want to convey today.

First, securitization can be a very effective mechanism for channeling capital into our economy to benefit the consumer and commercial sectors.

Second, as a result of the financial crisis, the residential mortgage-backed security market and the asset-backed market are
sharply bifurcated. As I will describe, some are performing well, some less so.

And then, finally, third, there are four broad areas of reform worthy of pursuit to help the securitized markets function better. In my remaining time, I will elaborate on these three points.

One of the most important benefits of the securitization process is that it provides loan originators an additional funding source as an alternative to conventional retail deposits. As an example, I manage the Fidelity Ginnie Mae Fund, which has doubled in size in the past year to over $7 billion in assets. The mortgage-backed security 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.

Second, to provide further insight into the value of securitization, consider what happened to the consumer ABS sector. From 2005 through 2007, auto and credit card ABS issuance was roughly $170 billion per year. However, after the collapse of Lehman Brothers in September of 2008, new issuance came to a virtual halt. As a result, the interest rate on new car loans provided by finance companies increased by about 5 percentage points between July of 2008 and year end. Issuance did not resume until March of this year, when the TALF program began. Thanks to TALF, between March and September, there was $91 billion of card and auto ABS issuance. Coincident with the resumption of a functioning auto ABS market, new car financing fell back into the 3 percent range.

I will now turn to the agency mortgage market, which is also performing well, thanks to the extraordinary Government intervention over the past year. This intervention has had two parts. First, in September of 2008, Fannie Mae and Freddie Mac were placed into conservatorship, thus reassuring tens of thousands of skittish agency MBS investors that the Government stood behind their investments.

Second, the Federal Reserve pledged to purchase $1.25 trillion of agency MBS by the end of 2009. So far, the Fed has purchased just over $900 billion, thus reducing significantly the spread between the yields on agency MBS and Treasuries. As of this week, the conforming balance 30-year fixed mortgage rate is approximately 4.85 percent, which is very close to a generational low. Furthermore, the agency MBS market is deep and liquid.

In contrast, the new issued private label mortgage market has received no Government support and has effectively shut down. From 2001 to 2006, issuance in this market had increased almost fourfold, to $1.2 trillion. But when the financial crisis hit, the issuance quickly fell to zero. Virtually the only source of financing for mortgage above the conforming loan limit, so-called “jumbo loans,” is a bank loan, and generally the available rates are not that attractive.

At first glance, the higher cost of jumbo financing may not seem to be an issue that should concern policymakers. But consider the following. If the cost of jumbo financing puts downward pressure on the price of homes costing, say, $800,000, then quite likely there
is going to be downward pressure on the homes costing $700,000 and so forth. So in my opinion, at the same time that policymakers deliberate the future of Fannie Mae and Freddie Mac, they should consider the future of mortgage finance in all price and credit quality tiers.

To help improve the functioning of the securitized markets, 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 a deal. For example, 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, strengthen credit underwriting standards in the originating process. One way to support this goal is to discourage upfront realization of issuers’ profits. This issue is complex and likely will require specialized rules tailored to each market sector.

Third, facilitate greater transparency of the methodology and assumptions used by the rating agencies to determine credit ratings. In particular, there should be a public disclosure of the main assumptions behind rating methodologies and models.

Finally, support simpler, more uniform capital structures in securitization deals. This goal may not be readily 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.

Thank you, and I look forward to answering your questions.

Chairman Reed. Thank you very much, Dr. Irving.

In fact, I wanted to thank all the witnesses for their not only very insightful, but very concise testimony. I appreciate it very much. All of your written statements will be made a part of the record and any of the statements that my colleagues wish to be submitted will be made part of the record.

Let me pose a question to all of you, which in some cases will allow you to elaborate on your initial comments. We have seen a— I am getting to the point now where I can say lifetime, and that is a long time—shift from a very small secondary market for loans to a well-functioning market, now to one that has basically seized up. I think some rough numbers that I have seen, that loans on bank balance sheets, roughly $3.5 trillion, compared to securitization products, about $7.1 trillion, and that market has sort of collapsed.

So the issue is how do we—or what are the key factors that are stalling this market and that have to be addressed by us? And again, I think you have alluded to some of them, but let me start with Professor McCoy and go down the row.

Ms. McCoy. Thank you. The problem right now on the investor end is lack of investor trust. Investors were not getting useful disclosures up front. They simply weren’t. They weren’t given information on the individual loans in the loan package so they could figure out whether the underwriting was good or bad. The due diligence done on those deals by investment banks left a lot to be de-
sired, and in some cases, I fear, was tantamount to fraud to the investors.

When I have looked at securitization prospectuses for mortgage-backed securities, often they would say, here are our underwriting standards. But many of the loans in the loan pool were exceptions to these standards, and there is no further description of the exception loans or how many of the loans in the loan pools are exception loans. In some cases, it was more than half, and I guarantee you they did not exceed the underwriting standards. They fell far below. So this is a pig in the poke, and for starters, that needs to be fixed.

My additional concern is that investors’ interests are not always protective of borrowers. We also need to rebuild securitization so that it does not saddle borrowers unknowingly with products that they cannot afford to repay, and that is a separate issue.

Chairman Reed. Mr. Miller? Thank you.

Mr. Miller. Senator, I think the reasons are interrelated. There are a number of them. I think I would agree, overall, if I had to characterize it, it would be a significant lack of confidence in various parts of securitization market activity. I think that it certainly relates to withdrawal of confidence from investors who are in parts of the market for the kind of data and data integrity and reliability to give them comfort that they are able to evaluate—making meaningful evaluations of securitized instruments. I think it clearly relates to similar lack of confidence in certain rating agency methods and processes.

Having said that, I think it is important to note that while there are clearly parts of the securitization market that are dormant and significantly challenged, there are other parts of the market that are functioning to some reasonable degree of normalcy, and while I think you can also point to Government programs, for example, TALF playing a significant role, TALF has also been beneficial in that it has brought back non-TALF issuance in investors for products that aren’t directly supported by Government loans. And I think what that reveals is that it is not something that is endemic to securitization as a whole, but there are specific and identifiable deficiencies that need to be addressed.

And so that is why, again, from ASF’s perspective, things that lie more perhaps within the industry’s control are areas where we are focusing to rebuild the securitization infrastructure, improve the quality, comparability, standardization, and reliability of data, and then finally to—and I think this goes to some of Andy’s comments, which I agree with—to help rebuild confidence in the operational processes and controls so that protective measures that are there to protect investors and ensure that their rights and entitlements as promised are delivered, that those protective measures actually work. And I think there is some significant work and effort that is needed in that area, but all directed at helping to rebuild and restore confidence.

Chairman Reed. Mr. Davidson.

Mr. Davidson. Addressing the current illiquidity, I would focus sort of on two different areas. One is the area of uncertainty. We still have a tremendous amount of economic uncertainty and regulatory uncertainty, and that just takes some investors out of the
market because they need the risks to know a little bit better. And the other area is just the lack of availability of leverage to certain types of instruments. Without leverage, many instruments have to trade at very discounted prices, and so the institutions who hold those now and do have leverage are not willing to transact at the all equity price as opposed to the leveraged price. And I think that is why some of the Government programs, like TALF, have been so effective is because they have reinstated leverage into these markets.

In thinking about the solutions, we have to consider what is the appropriate amount of leverage and make sure that that can be delivered through those markets because that will be an important part of their future success.

Chairman Reed. Thank you.

Mr. Hoeffel, you can also focus in on the commercial loan——

Mr. Hoeffel. Yes. I will definitely have a bent to that. I will look at it from both the investor and the lender point of view, or the originator or issuer point of view.

For investors, one of the issues, as Mr. Davidson mentions, is their inability to finance their investments, so that has caused spreads to be very volatile and, in general, trend toward higher spreads than what we had seen when the market was healthier. TALF has certainly helped that from a secondary point of view, some of the existing securities, and may help in some new issues if we get some deals done, but that is yet to be seen.

There are certainly concerns about the rating agencies and the rating process, not that they were necessarily wrong, but as I think several people have mentioned, we need greater transparency so investors can understand what the rating process is and delve in and do their own critical analysis of what the ratings mean.

And third, from an investor point of view, I think there are concerns about the continuous changes in accounting and regulatory policies. They don’t know what the potential ramifications of investing in a security might be down the road because some of the FASB rules keep changing and there is a certain amount of uncertainty there that is unpalatable.

From a lender point of view, because, again, of the volatility of credit spreads, in order to make a loan work, you would have to originate it at a pretty high spread today and that is not competitive to the few people that are active in the markets. Some banks and life companies are making new commercial mortgages.

Second, there is a big challenge in the commercial real estate space to aggregate collateral. In a healthy market, it takes 3 to 6 months to aggregate sufficient loans to do a securitization. Today’s market, it would probably be longer. Typically, lenders would hedge their positions against movement in credit spreads or interest rates during that aggregation period through a number of different derivative options that don’t exist right now, or are so uncorrelated to the market that they can’t really use them to effectively hedge. So people are unwilling to take the balance sheet risk to aggregate loans solely for securitization.

And similarly, lenders or aggregators are concerned about ongoing accounting changes in the market and how that might affect them while they are aggregating, but before they sell.
Chairman Reed. Thank you.

Mr. Irving. I will make four comments. First of all, I think uncertainty about home prices and how borrowers behave when they are underwater on their mortgage, when the loan-to-value ratio is greater than 100, has increased the risk premium in the market. And the second facet of uncertainty which is causing skittishness about these securities is just uncertainty about Government policy. The Government in some sense has been in the position inadvertantly of picking winners and losers in terms of which investments do well and which do not. Those that get the Government support perform better than those that do not, so it becomes less of an intrinsic relative value of the cash-flows and more an assessment of how the Government policy is going to go.

The third would be the equity-like price volatility that we have seen exhibited in many of these marketplaces, again causes there to need to be an increased risk premium, that is, prices go down. And then finally, the complexity. We have sort of a rule of thumb on our trading room floor that for every additional sentence I need to describe to my boss the structure of the security I am buying, the price has to be lower by about a point, and——

Chairman Reed. That would be terrible here. [Laughter.]

Chairman Reed. Thank you, Dr. Irving. And one point, I think, emerges, and I am going to turn it over to Senator Bunning, is as we proceed forward on financial reform legislation, that will provide one way of at least an additional degree of certainty and calculation of the market, so that might contribute to, in a small way, to expanding this market.

Senator Bunning.

Senator Bunning. Thank you, Mr. Chairman. I am going to start on the other side. Without reform of bank capital standards, rating agencies, and housing subsidies like the GSEs, is there any way the private asset-backed security market will ever return?

Mr. Irving. So first of all, we do have evidence that—from the TALF program for a number of——

Senator Bunning. That is Government-backed, though.

Mr. Irving. No, but where I am going to go with that is that certain high-quality issuers are no longer relying on the TALF program. They can do issuance without the benefit of the Government subsidy.

More generally, though, I would say that the past year’s experience would suggest that in the residential mortgage market, some sort of a Government guarantee is probably going to be required, and the evidence that I would put forth to that would be if you look at the striking difference between the performance of the agency market, even before the Fannie Mae–Freddie Mac conservatorship, and a nonagency market, where in the nonagency market, even prime jumbo responsible loans with a loan-to-value ratio of 70 were priced at, like, 80 cents on the dollar, there was so much furor in the marketplace and so much concern, that I think that that evidence suggests to me that in times of tremendous stress, at least, there needs to be some sort of a Government backstop. That is not
to say necessarily you need to have organizations with large retained portfolios, but some sort of a Government guarantee or credit guarantee, in my opinion.

Senator Bunning. Another question. Which problems that surfaced in the asset-backed securities markets can be solved by market participants on their own, and which need Government action? All of them, or just some of them?

Mr. Irving. Well, for instance, I think that in terms of aligning the interests, one of the key principles is to align the interests of the investors and the issuers. For instance, there is the proposal of issuers retaining a 5-percent slice of the security. I would say that that is far too blunt an instrument, and what we need instead is to take a step back and set up an overall regulatory environment and then let that regulator work with a trade organization like ASF to—and CMSA and come up with more detailed rules that are tailored to each particular sector of the market.

So, for instance, in that case of aligning the interests of the investors and the issuers, I think that is something that a regulator should do by working closely with the organization to tailor solutions for each individual marketplace.

I think maybe one area where legislative could help would be in terms of disclosure in the rating agencies, so we have fuller transparency on their methods and quicker turnaround when there is changing to their methodology or when they discover errors in their process.

Senator Bunning. Mr. Miller, you mentioned that there were about $12 trillion worth of assets. How much would you say of that is near or under water?

Mr. Miller. Well, from a, I think—and we can look into this and get back to you with specific detail, but the $12 trillion refers to the amount of securitized assets currently outstanding——

Senator Bunning. That is correct. I understand that.

Mr. Miller. Right. I think a very small minority of that would be in technical default, so that the securitized instruments are not paying as promised——

Senator Bunning. We have approximately five million homeowners that are in foreclosure or are—obviously, their houses are worth less than their mortgages.

Mr. Miller. Right. And I am distinguishing here—I am speaking at the security level, so the mortgage——

Senator Bunning. I understand that, but those securitized mortgages were the things that were sold as AAA rated, and that is where we got into all kind of the devil is in the details. And I find that the rating agencies were right in the middle of all that. In other words, they were the ones that were selling those as AAA quality to not only other banks, but the same banks that had sold them the mortgages in the first place, and all around the world. And that is why when the bubble burst, it didn’t just burst here in the United States, it burst in Europe and other places.

Mr. Miller. I would certainly agree with that, and to the extent that rating agencies were overly optimistic or miscalculated in terms of their assessment of credit——

Senator Bunning. Do you think they did due diligence in finding out exactly what kind of mortgages they were securitizing?
Mr. MILLER. I don’t think the rating agencies traditionally have performed due diligence on the underlying mortgages. I do think—I guess the point that I was going to make is that to the extent they did get it wrong, I think, number one, it emphasizes the critical importance of avoiding undue reliance on rating agencies by all parties.

And then, second, as I indicated in my earlier testimony, I think one of the core features of reform that will assist issues and problems with the rating agencies and many other issues and deficiencies that we have identified is simply having access to better data that can then support better due diligence, better quality assurance, better rating agency processes in a much more transparent way. I think part of the problem is that judgments made by rating agencies and others were really not easily capable of similar evaluation by others.

Senator BUNNING. Meaning, in other words, being able to distinguish the mortgages that were in the portfolio——

Mr. MILLER. Yes.

Senator BUNNING. ——that they were doing.

Mr. MILLER. That is certainly part of it.

Senator BUNNING. Are all of you familiar with the 1994 law that the Congress passed giving the Federal Reserve the jurisdiction over all banks making mortgages and also the mortgage brokers that were making mortgages? They were empowered with oversight—the Federal Reserve was—to see that they were doing their job. In other words, they were watching the store. And it was exactly 14 years from the day that we passed that bill that the first regulation was written, and that was 2 years into Chairman Bernanke’s oversight, the first regulations were promulgated on mortgages. So we went 14 years without a regulation. Would someone like to comment on that?

Ms. MCCOY. Senator, I am very familiar with that history.

Senator BUNNING. OK.

Ms. MCCOY. I am actually writing a book on it.

[Laughter.]

Senator BUNNING. I have spoken enough to write a book on it, so——

[Laughter.]

Ms. MCCOY. I was on the Consumer Advisory Council for the Federal Reserve from 2002 to 2004. We begged the Federal Reserve to exercise that power. We were aware of the burgeoning problems with the subprime market at that time, and I was privately told by Governor Gramlich that he very much supported that rule, but it would never fly with the Board.

Senator BUNNING. Oh, really?

Ms. MCCOY. Yes.

Senator BUNNING. Well, it is funny, but the Congress of the United States gave that power to the Federal Reserve and expected them to completely fulfill their obligation in oversight of the mortgage market, whether it be the bank or whether it be the mortgage broker.

Ms. MCCOY. When we would talk to Federal Reserve staff during that time period, we were told that we only had anecdotes to offer,
that we could not produce proof of a deleterious effect on the macroeconomy, and that, therefore, the Board would not take action.

Senator Bunning. Well, I can tell you when Chairman Greenspan and Chairman Bernanke came before this Banking Committee as a whole, they were all warned about it, especially early in the early 2000s, that we were getting ourselves into a potential bubble situation like we did in the dot-com bubble, and we couldn’t get action out of the Federal Reserve. I am just wondering if anybody here was aware of that. No one here was aware that the Fed had that power except the person who was in direct contact with the Federal Reserve?

Ms. McCoy. Yes.

Senator Bunning. OK. Thank you very much.

Chairman Reed. Thank you, Senator Bunning.

Senator Corker.

Senator Corker. Since I was in another hearing, I am going to let Senator Gregg go and I will go after him.

Chairman Reed. Senator Gregg.

Senator Gregg. That is very kind of you, Senator.

First off, I thought your testimony was exceptional and very, very helpful and constructive, everyone’s, and the fact that you were concise and had specific thoughts and ideas as to what we should do is extremely useful.

My opening thought, though, however, as I listened to all of you, was does any of this need to be legislated? It sounds to me like almost every specific proposal you have suggested should fall to a regulatory agency to do, and most of it went to underwriting and better underwriting standards, it seemed like. So I would ask anybody on the panel, is there anything here that needs legislation to accomplish it versus just having the proper regulatory agencies noticed that this is the way we should approach these issues?

Ms. McCoy. Senator, if I may, I have jotted down eight different things, and we can divide them between the private market and Government intervention.

I think representations and warranties, recourse clauses, standardizing products, and having a functioning resale market for mortgage-backed securities is probably a private sector function, although the Government might convene discussions along those lines.

But for Government action——

Senator Gregg. I am talking about Congressional action, not——

Ms. McCoy. Yes. Yes. I believe that better disclosures to investors can be handled by the SEC directly and Congress does not need to intervene there.

Better underwriting standards, I think, do need Congressional action because the Fed is still not sufficiently aggressive and there is very strong legislation in both chambers along those lines.

Higher capital standards, I believe banking regulators will address.

Rating agency reform may very well need Congressional attention.

Senator Gregg. I would just note that I think if you are going to have a uniform underwriting standard, you don’t want that written into law if you want to have flexibility on how——
Ms. McCoy. Yes, but I believe——

Senator Gregg. That is going to require some mutation.

Ms. McCoy. The authorization needs to come from Congress and then delegated, I have proposed, to the new agency.

Senator Gregg. You don't think that power already exists within the Fed or——

Ms. McCoy. Well, the power may exist within the Fed, but the Fed is not exercising it effectively.

Senator Gregg. OK. So does anybody else have Congressional action that is required?

Mr. Davidson. Senator Gregg, certainly in the area of Fannie Mae and Freddie Mac, which is central to the mortgage-backed securities market——

Senator Gregg. Yes, I accept that.

Mr. Davidson. ——Congressional action is necessary. And then that would have a number of spillover effects, depending on how that process went, that may or may not require further Congressional action.

Senator Gregg. Does anybody else have anything? You know, this does come down to underwriting. Everybody used that as an example of where the problem lies. Should we move toward a system like the Australians have, where you basically have to put a certain percent down—in Australia, I think it is 20 percent—then you have recourse on mortgages. Or should we continue with the system of the Congress telling everybody in America that they have a right to have a loan to buy a house, no matter whether they can pay it back or not, through the CRA? Or is there someplace in between?

Mr. Hoeffel. Senator, I don't think you need to regulate underwriting per se. I think you need to make sure that potential investors who might be impacted by the underwriting are fully aware of what they are investing in, so that if the underwriting has been poor, it is not glazed over by a rating or a structure. They have all the information they need to make the proper assessments.

Mr. Miller. I would agree. I don't think it is desirable to legislate or regulate underwriting standards per se. I do think it is important, though, for those involved in credit underwriting functions, and I am thinking specifically in the residential mortgage market, for those involved in those activities—mortgage lenders, brokers, and others—to be subject to the same type of regulation so that you have a level playing field and consistent standards that apply to all who are engaged in those functions.

Ms. McCoy. I am forced to disagree. We saw a situation in which the residential mortgage lending industry was unable to organize self-regulation, and, in fact, engaged in a race to the bottom in lending standards, which was aided and abetted by our fragmented regulatory system which, as Senator Bunning noted, refused to impose strong standards. That is how we got in this mess, and I think the only way that we prevent that from happening is to have some basic common sense standards that apply to all lenders in all States from the Federal Government.

To my mind, the most important one is require borrowers to produce documentation that they have the ability to repay the loan
at inception. That is common sense. We don’t have to obsess about down payment requirements. But that, to me, is essential.

Senator Gregg. I don’t want to—doesn’t that go to recourse? I mean, should there be recourse?

Ms. McCoy. Against the borrower?

Senator Gregg. Right. Should that be a standard that we subscribe to in this country, which we don’t now?

Ms. McCoy. Well, some States do subscribe to it. It depends on the State.

Senator Gregg. Well, is it a good idea or bad idea?

Ms. McCoy. I think right now, it is causing people who have already lost their houses to be pushed further into crisis and it is not helping the situation right now.

Senator Gregg. And didn’t this push to the bottom—wasn’t the shove given by the Congress with the CRA and the way it set up Fannie Mae and Freddie Mac as basically guaranteed entities?

Ms. McCoy. Actually, CRA loans have turned out to perform pretty well, and one of the reasons is that banks held them in portfolios so that those higher underwriting standards actually applied to CRA loans. They have been a success story among different classes of loans.

Fannie Mae and Freddie Mac, I agree, they cut their underwriting standards, but they joined the bandwagon late. The private label nonconforming loans created a strong competitive threat that they felt necessary to meet, and so they were not the cause of the problem, although they did join the bandwagon.

Senator Gregg. Thank you.

Chairman Reed. Senator Corker.

Senator Corker. Thank you, Mr. Chairman, and I am sorry I missed part of the end of the testimony going to another hearing, but I got the general idea.

Focusing on commercial real estate right now, I know there has been a lot of discussion. We were just in New York, lots of people concerned about this huge amount of indebtedness that is coming due, huge amounts of loans done 10 years ago. You had 10-year term, 30-year ARM. In essence, you kind of sold the project at that time because it was almost—you almost got full value because underwriting was so loose, so you kind of wondered, what is the problem? These have got to roll over, and the developer kind of sold the deal on the front end.

But I guess as we—and I know that is not the case in every case. But what is the key? Some organization that wants to begin originating commercial real estate loans again and securitizing them from just doing those things and market needs to make those be sold by keeping recourse or doing other kinds of things? I just don’t get it, really. The real estate values are dropping. You are underwriting at lower levels. The bond holders today are going to take a haircut to get financed out. The developer is going to have a little bit different deal or lose his property, but what is to keep the private market from just functioning right now? I really don’t get it, and I don’t understand why the focus is on us.

Mr. Hoeffel. Well, there are a couple of different responses. One is that there are loans being made by insurance companies and some banks that are holding those loans—
Senator CORKER. Right.
Mr. Hoeffel. So that business is happening. Unfortunately——
Senator CORKER. And it is heating up a little bit, isn't it?
Mr. Hoeffel. It has picked up, but there is just not a capacity
for banks and insurance companies to fill the void that is left by
the absence of securitization. They just don't have the balance
sheet strength or size to write all the loans that need to be written.
But it can be done.
For the securitized, and you may have missed these comments,
there is a mechanical issue in that there are a lot of people who
would like to go and make loans to securitize, but it takes a great
deal of time to aggregate a sufficient pool to go out and create a
pool to securitize. It was 3 to 6 months. It may be 6 to 12 months
today just because the market has slowed down.
Traditionally, issuers would hedge their positions against move-
ments in credit spreads or interest rates during that aggregation
period, but there really aren't any instruments to do that now.
There is no efficient way for them to warehouse their lines while
they are—warehouse their portfolios while they are aggregating or
hedge those specific interest rate risks—not credit risk, not credit
of the underlying asset, but just movements in market spreads.
And until that really exists, people are not willing to take on the
balance sheet strain of aggregating a billion dollars' worth of new
commercial mortgages, even if they are underwritten to lower val-
ues and better standards.
Plus, there is so much uncertainty on what the ultimate execu-
tion might be for those securitizations. It is kind of a chicken and
the egg. Once a few securitizations get done, an index will be able
to be created so people can use that to hedge their positions. But
until that happens——
Senator CORKER. Let me ask you, so I would assume there are,
like, trillions of dollars of legacy securitizations that already are
pulled together.
Mr. Hoeffel. Mm-hmm.
Senator CORKER. People have an operating history on those port-
folios. So there would be no risk in aggregation. Those exist. So
why isn't there a market to at least deal with the legacy issues?
Why aren't people cranking that up and going in and writing those
assets down? The operating history is there. I don't understand
why that is not occurring and why somebody isn't willing just to
put up some recourse liability to make that get done and move on.
Mr. Hoeffel. There is a market for both legacy loans and legacy
securities. The securities market has been helped by TALF as an
ability to finance those acquisitions, but there has been both TALF-
financed and non-TALF-financed trading of mortgage securities.
For whole loans, there is a market, as well, but those loans are
being purchased based on new values and that requires the seller
to recognize a loss, and many times sellers don't want to recognize
that loss if they don't have to. So if a loan is written to $100 and
the market value based on what you think the property is worth
is $70, to sell the loan, you would sell it for $70 or less and then
the owner of the loan would have to recognize a $30 loss.
Well, if the mortgage is performing, it is a 10-year loan and there
is sufficient cash-flow today to service that loan, the seller is going
to forestall that sale until they ultimately have to, and hopefully between now and the time that loan matures, the value of the underlying asset may improve. So there hasn’t been a lot of impetus for holders of whole loans to sell.

Senator Corker. So back to the securitization—is it OK if I continue?

Chairman Reed. Go ahead.

Senator Corker. Back to the securitization piece, I assume that what is happening on that side is the loans are just being extended, and if you happen to own some of those securities, you are just in them longer than you anticipated being in those securities.

Mr. Hoeffel. That decision is being made by the servicers alone on a case-by-case basis. In some cases, they are being extended. In some cases, they are being foreclosed or otherwise worked out. So there has been resolution, but there is just such a wave of requests for work-outs and modifications, it is going to take time to get through that.

Senator Corker. What role should—you know, there is a lot of discussion here about covered bonds, and I realize that at the volume levels we are talking about, it is not going to certainly supplant the need for securitizations down the road, but what level of faith should we as policymakers have in the cover loan process here in our country as it relates to commercial real estate?

Mr. Hoeffel. I think we want to not do anything that precludes commercial mortgages from being eligible to be in a covered bond issue. I don’t think it is going to be the solution. It can be another tool to provide liquidity to the commercial real estate market, but because banks or the issuer has to keep those assets on their balance sheet and there will be regulatory capital requirements against those assets, it is a tool, but it is not going to be a sufficient tool to fill the void.

Senator Corker. Let me just ask one more question.

Chairman Reed. Take your time.

Senator Corker. Do you think there is a sense among a lot of the larger players that we are going to do something here? I am hearing that from some of the larger players, and so instead of going ahead and taking some of these write-downs and moving on and sort of taking the pain, they are waiting, thinking that either through TARP or some other mechanism here, we are going to create a solution.

Mr. Hoeffel. There is hope that something will happen, and some players are—may be waiting. I think it would be difficult to justify to sit around and wait for something to happen if you don’t know it is going to happen, but that may be, in fact, the case.

Senator Corker. Would it be a good signal to the market to let everybody know that TARP is over at the end of the year, that the circumstances that created the need for it are different and not there today, and would that help the market sort of move along versus this hope that there is a possibility that there won’t be as great a loss and, therefore, let us hold on and not do the write-downs now?

Mr. Hoeffel. I think TARP and the TALF financing for commercial real estate has been a help. It has created liquidity and it has created trading volumes. Certainty, I think, is always beneficial. If
people know absolutely when something is going to start and when it is going to stop, the market can react to it, and the market may not always react favorably, but it will react one way or the other. And I think part of the problem with some of these programs is they have had fits and starts, and people think it is going to go one way and then it goes another or dates aren’t certain. So the market will react one way or another to certainty and I think certainty is beneficial for everybody.

Senator Corker. Would anybody like to respond to the certainty of people knowing that this is a private sector issue? We may do some regulatory reform down the road, and I know Mr. Miller had some concerns about what some of those might be, and I guess in another setting we will probe those, but does anybody else want to respond to the people who are involved in commercial real estate financing knowing that nothing else is going to occur? Would that alone not help move along the process to some degree?

Mr. Davidson. You know, the Government had become, through various programs, both the Fed, Treasury, TARP, TALF, PPIP, very involved in the financing of a wide variety of financial instruments, and I think rapidly removing all of those at once will certainly be detrimental to the market because there are no other mechanisms in place now. So I agree with the idea that certainty is important, but I also believe that there needs to be a transition period, given how extensive Government’s involvement currently is in financing.

Mr. Hoeffel. One clarification. It is not only certainty what Congressional action will be, but certainty of what the regulators are going to do and what the accountants are going to do, because all of those things have been interplaying and some of the good work that is done here is undermined by work that is done elsewhere in Washington or in Connecticut. So I think you need certainty on all fronts.

Senator Corker. And I would just close by saying that in the event we did end TALF as, I think, everybody had hoped might happen at the end of the year, the programs that are funded right now, TALF and others, they would continue on until they ran out. So it wouldn’t be like all the Government assistance that is occurring today would end at the same time. It is just there would be no more commitments.

Thank you all for your testimony.

Chairman Reed. Thank you, Senator Corker.

Let me begin a second round with a question that Mr. Hoeffel and others have raised, which is the FASB’s role in the securitization process, particularly Statements 166 and 167, but all of the FASB rules affect this. Let us start with Mr. Hoeffel. Can you comment about how that might be inhibiting and what might be due to help FASB?

Mr. Hoeffel. OK. Well, FAS 166 and 167 get rid of the QSP, the qualified special purpose entity, that was the vehicle through which many securitizations were done. On a going-forward basis, I think we can work with that, but one of the key issues is that it is retroactive, so that people who have invested a small part of a securitization pool, maybe the bottom five to 10 percent, will be forced to consolidate all of the assets and all of the liabilities for
that transaction onto their balance sheet, which could give them rate cap issues or low covenants, if they are a private company, on their financing. So it is a real challenge.

It is almost impossible for these companies to get audited after the fact because they would have to consolidate everything down to the individual loan level, which may or may not be feasible given the terms of the loans themselves. So it is a significant challenge to the market.

And further, given that there is some weakness in property markets, if a certain class got wiped out through recognized losses or realized losses, you could have the next bond holder have to consolidate. So you could theoretically have a BBB or a single-A investor suddenly have to consolidate, and that is not something they had envisioned at all when they bought those bonds.

That will be specific to certain issues, but it is a challenge, both the lack of QSP for new issue and the consolidation that would happen for existing debt that is out there.

Chairman REED. Any other comments? Mr. Miller.

Mr. MILLER. Thank you, Mr. Chairman. Just extending those comments a little bit to other parts of the securitization market, at a macro level, the outcome of the 166 and 167 accounting standards changes will be to require a large volume of securitized assets in many different product sectors to be put back onto balance sheets or to prevent them from moving off balance sheet.

And our position—I want to be clear about this—is we are not for or against on- or off-balance sheet accounting. We simply think the accounting should be appropriate in light of exposure to risks or entitlement to assets. We think FASB's outcome in these standards is to—will result in an over-consolidation of many of these vehicles where the consolidating party really does not have meaningful entitlements to the benefits of those assets or exposure to the risks.

Having said that, the standards have been—will be adopted. They will generally take effect in January. I think our bigger concern at this point, as I mentioned earlier, is the ripple effects of those accounting standards changes. If you picture a very large volume of assets coming back onto bank balance sheets exactly at a time when those balance sheets are already very constrained, the larger asset side of the balance sheets will attract higher regulatory capital charges. They will factor into leverage ratio calculations. They will attract loan loss reserves.

And our concern, and we have heard this very forcefully from our members across a wide range of markets, is that that, coupled with other steps being considered, may constrict the ability of financial institutions to use their capital base to support new lending. And so we are very concerned, both about the accounting standards changes, but even more so now about the downstream impacts that those may have.

Chairman REED. Any other comments on this issue?

Mr. HOEFFEL. One other thought is that the 5-percent retention that is being discussed in the regulatory reform proposals will—this sort of flies in the fact of that, because if you are required to retain 5 percent, now you are going to have to consolidate. So it exacerbates some of the issues that Mr. Miller mentioned.
Chairman Reed. Let me raise another issue with Mr. Hoeffel, and anyone else, and that is, there seems to be one distinction between residential mortgage-backed securitization and remedies and commercial, which is commercial bankruptcy code is available to the individual mortgages if they default. Is that a difference that makes a difference in terms of the commercial market versus the residential market?

Mr. Hoeffel. I think it will impact the resolution of workouts, and we have seen that forestall some of the workouts that have happened in some very large securitizations to date. We are still waiting to hear what the outcome of some of those cases are.

So, again, I think that process, because commercial borrowers can file for bankruptcy—we have tried to avoid that through recourse carveouts for bankruptcy, but even that seems to be not as enforceable as maybe some people had thought. So it does create, again, more uncertainty, which is a challenge for investors going forward.

Chairman Reed. But at least in the commercial context, the access to bankruptcy was clearly understood before the securitization process took place. And I guess the question would be if someone has the ability to work it out, it is understood beforehand. That is anticipated by the investors. Does that facilitate the process at all or is it sort of neutral?

Mr. Hoeffel. Well, investors always knew that bankruptcy was an option and always has been. We tried structurally to limit a borrower's ability to file for a bankruptcy by putting most securitized loans into special purpose entities where you needed unanimity of all the directors to file for bankruptcy, and there you had independent directors that would not file for bankruptcy on a solvent entity. Again, there have been some court challenges to that, and many of us are waiting to find out what will happen.

Nobody thought that commercial real estate, even in an SPE, was completely bankruptcy proof, but we did think that there were enough hurdles to that to provide protections for investors.

Chairman Reed. Thank you.

Professor McCoy, you have suggested that borrowers be given an affirmative claim against assignees, a violation of Federal lending standards. Can you elaborate on that? Then I would ask others to comment on that proposal.

Ms. McCoy. Yes, I would be glad to. We are in a situation right now where in the majority of States, if a borrower's loan is sold, generally through securitization, they lose, without their consent, their defenses to collection and their ability to sue the holder of the loan for consumer protection violations and fraud. And where the rubber really hits the road is when that borrower is sued for foreclosure.

If the loan has been securitized, let us say the borrower was defrauded originally, the loan later goes into foreclosure, under State law the borrower cannot raise the fraud as a defense to foreclosure. They lost that, and they lost that through a process over which they had no say.

In addition, because the borrowers can really only sue their lender, or their mortgage broker, it means that we do not have the threat of making the borrower whole that investment banks have
to care about; that investors have to care about when they think about will we do due diligence or just rely on the rating agency.

And I feel in order to bring rationality and consistency to the entire mortgage process, we need to allow borrowers to bring claims of fraud and consumer protection violations against whoever holds their loan.

Now, there are ways you can structure this liability that rating agencies can rate and that securitization can function with. Economists and I and other coauthors studied the effect of similar laws in nine States, and what we found is in six of those States, access to subprime credit actually increased, holding everyone else constant, despite assignee liability.

In three of the States, depending on the indicator, the results were mixed, but in no State was there an affirmative drop in access to credit.

Chairman REED. And I am going to ask others to comment on this, obviously, but to follow up, would this be a way to complement or displace the requirement of the Administration to hold 5 percent of a mortgage or 5 percent to give the originator sort of some skin in the game or——

Ms. MCCOY. I view it as a complement. I am supportive of the Administration's 5-percent retention measure, but my concern is even though the Administration would prohibit hedging it, I do not think that that prohibition is enforceable because often hedges are taken on a broad variety of positions. And there is a lot of devil in the details with respect to that proposal, so I would have assignee liability as well.

Chairman REED. Mr. Miller, and anyone else who wants to jump in on this issue.

Mr. MILLER. Certainly borrowers should have remedies and defenses against fraud that may relate proximately to a foreclosure action against them. The details, though, of any assignee liability mechanisms are very, very important and should be addressed at that level of detail. But, broadly speaking, the securitization industry would have very significant concerns about broad-based assignee liability. While, again, the interests of the borrowers here are primary, at the same time those borrower interests are also served by having investors who are willing to commit capital to the mortgage-backed securities markets. And if those investors are potentially subject to downstream claims by borrowers for origination defects over which they have absolutely no ability to perform diligence upon or to verify, they are not sitting at the loan closing table, my fear is that and I think the industry's fear is that if those types of assignee liability provisions are broadly introduced, it will significantly curtail, if not dry up completely, the willingness of investors to take that risk. If it is not a risk that they can manage, I do not believe that it is a risk that they are broadly going to undertake. So there are some very significant competing considerations that would weigh against broad-based assignee liability.

Chairman REED. Just a follow-up. Would one of aspect of this might be that those investors would be much more careful about what they are buying and what they are investing in? Because they would like to make sure that the originator was doing their job in underwriting and that would be a market solution to this problem.
Mr. MILLER. I think they certainly want to be and will be more careful. I think the issue, though, is whether they really are in a position even with the extreme time and effort and due diligence to be able to know whether, in fact, fraud was committed. I do not think they can be in that position, and so there, I do not think that at least it is a universal solution or market-based response that could work.

Chairman REED. Thank you.

Mr. Davidson, do you have a comment?

Mr. DAVIDSON. Sure. In both my written statement and oral statement, I mentioned this idea of an origination certificate.

Chairman REED. Right.

Mr. DAVIDSON. And the idea of that is an alternative to both the assignee liability and the current way that representations and warranties travel through the system. And the idea there is to say that these are the obligations of the originator and that that tracks along with the loan, or whoever the investor is, and stays as an obligation back to the borrower, and that we also track through a bonding system or other capital system capital of that originator or lender so that in the case there are violations of representations and warranties or there is fraud against the borrower, there is money to go after. And so this puts the responsibility in the hands of the person who created the problem rather than other parties who really, as Mr. Miller has said, cannot really know exactly what happened.

Chairman REED. All right. And, Mr. Miller, you have also suggested a unique identification number for loans. How would that work? And would it work in conjunction with Mr. Davidson’s proposal? Or what other aspects would it help?

Mr. MILLER. I think that it would, and just building on what Mr. Davidson just indicated, I think also the representations and warranties and enhancements there are really, I think, very consistent with what he was stating in terms of creating an ongoing economic responsibility. His proposal is a bit of a variation on that theme.

I think the unique loan identifier, which ASF has recently announced, will broadly assist the process of being able to drill down to the individual level of the mortgage loan as that makes its way into the secondary and debt capital market so that no matter what type of securities structure—it could be a whole loan sale, it could be a mortgage-backed securitization, it could be another type of instrument down the road—investors and other parties would be able to identify the specific loans underlying that instrument and coupled with the other data, standardization enhancements through Project Restart, be able to perform analytics at a very deep level of detail, providing investors and other market participants with a much better window into the performance characteristics and risk profiles of those loans and, thus, the securities that they are a part of.

Chairman REED. Thank you. One final area of questioning, and that is, many of these securitizations depend on REMIC, the real estate conduit tax treatment. And there has been some discussion that because of the structure of these vehicles, it is very difficult to modify mortgages held in them because in some cases it requires unanimous consent, which is hard to get if you are at the lowest
tranche. And I am wondering as we go forward, should we consider conditioning this favorable treatment on an agreement to modify loans that are financially appropriate? I mean, you know, not subsidized loans, but if the modification will have a value more than a foreclosure, then that should be done? Professor McCoy, and then anyone else who wants to comment.

Ms. McCoy. Yes, I think this is essential. There seem to be three impediments right now. One is that perhaps the REMIC rules themselves discourage workouts, although the IRS has been trying to soften that.

The second problem is servicer compensation often is more lucrative if you go to foreclosure. That is a separate problem that needs to be fixed.

But, last, servicers do have some justifiable fear that they will be sued by one set of tranche holders if they benefit another in the process of doing a good-faith workout. And I think we can use the REMIC rules to say the trust will not receive Federal tax favored treatment unless these problems are solved, so that when workouts are cost effective, that they go forward, and the servicer has the incentive to do it and is not worried about lawsuits.

If I could work in one other thing?

Chairman Reed. Yes, please.

Ms. McCoy. Which is with respect to assignee liability, again and again we hear this claim that investors will not come to the table if there is carefully crafted assignee liability that does not expect investors to do the impossible. In fact, in States that had carefully crafted standards, investors did fund those loans.

What drove them away was the failure of securitization. So it is ironic to talk about assignee liability driving them away when securitization was able to do that just fine on its own.

Chairman Reed. Any other comments, particularly on this REMIC question? Mr. Miller.

Mr. Miller. Yes, I do not think that the REMIC regulations are themselves an impediment at all to loan modifications that are otherwise contractually permitted. I think it is really quite well established that under the REMIC regulations, if a mortgage loan is in default or that default is reasonably foreseeable, which covers, I think, a lot of territory, that a loan modification can be pursued—again, subject to any contractual requirements in the securitization itself.

Having said that, I do not believe that it would be advisable public policy to condition REMIC qualification or continuing REMIC qualification on requirements to perform modifications or to do that in a certain way. Again, I think that would threaten the tax treatment that is provided through the REMIC regulations in a way that would, again, chill or inhibit participation and create distortions in the marketplace.

To the extent that there are solutions or improvements to the loan modification process, I think we should address those frontally and head on. Part of Project Restart looking forward prospectively is to support changes and develop standardized provisions governing loan modifications and loss mitigation for future securitization transactions to address uncertainties or ambiguities in the way that that language is currently constructed in those
transactions. So I think the better way would be to address it directly and not indirectly through the Tax Code.

Chairman Reed. Just a follow-up question. The point that Professor McCoy makes about the incentives for services financially, in some cases—not all, obviously—that foreclosure provides them more income than a modification, which takes time, et cetera, and that seems to be a classic case of the obvious benefit to one person but socially a cost to all of us because as more and more mortgages go into default and foreclosure, it is hurting the economy grievously.

So is that something that we can correct or should correct?

Mr. Miller. Well, I think the answer that I would give to that is, regardless of incentives of any of the parties who are involved in that circumstance, again, at least in the securitization context, the duties and obligations and responsibilities of servicers are laid out in the contracts, they are and should be held to those standards by investors and others. So regardless of any potential incentive that they may have—and I personally think that some of the arguments about servicing incentives to foreclose as opposed to, you know, taking reasonable workout strategies, especially where that can yield a greater net present value, I think some of those statements are overstated or exaggerated. But, again, you know, I think that really is something that is determined and dictated by contract and the parties should be held to their contractual obligations.

Chairman Reed. Just a final point. You are talking about prospectively fixing this system. But currently we are looking at estimates range from 4 million to 6 million foreclosures next year, which is a huge drag on the economy and which may, in fact, be sufficient drag to cutoff or at least to deflect the growth and the prosperity we are all hoping for.

So I think we are confronting—I applaud your efforts to go forward prospectively, but we have a huge problem with what we have to deal with right now.

Anyone else who has a comment on this topic?

[No response.]

Chairman Reed. If not, let me thank you all again for excellent testimony. I think Senator Gregg said it very well: great insights together with very specific suggestions and done in a very concise and understandable way. So thank you all for your wonderful testimony.

The hearing is adjourned.

[Whereupon, at 4:11 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]
I want to welcome everyone and thank our witnesses for appearing today. This hearing will examine a key activity within our financial markets—the securitization of mortgages and other assets—and will build on previous hearings this Subcommittee has held to address various aspects of regulatory modernization, including hedge funds, derivatives, corporate governance, SEC enforcement, and risk management at large financial institutions.

Securitization is the packaging of individual loans or other debt instruments into marketable securities to be purchased by investors. At its core, this process helps free lenders to make more loans available for families to purchase items like homes and cars and for small businesses to thrive.

But we have learned from the financial crisis that securitization, or how it is conducted, can also be extremely harmful to financial markets and families without appropriate diligence and oversight. Arguably, many of the basic requirements needed for effective securitization were not met. Today's panel will discuss how in recent years the securitization process created incentives throughout the chain of participants to emphasize loan volume over loan quality, contributing to the build-up and collapse of the subprime mortgage market and the broader economy.

Today we find ourselves in the opposite position from a few years back, with hardly any issuances in key markets that could help return lending to responsible levels. So this afternoon's hearing is about how to strengthen the securitization markets and enact any needed changes to ensure that securitization can be used in ways that expand credit without harming consumers and the capital markets.

I have asked today's witnesses to address a number of key issues, including the role securitization played in the financial crisis, the current conditions of these markets, and what changes may be needed to Federal oversight of the securitization process.

Unfortunately, a number of the banks who issue these securities could not find anyone in their workforce who was willing to testify today.

I welcome you all and look forward to your testimony.

PATRICIA A. McCOY
GEORGE J. AND HELEN M. ENGLAND PROFESSOR OF LAW, AND DIRECTOR, INSURANCE LAW CENTER, UNIVERSITY OF CONNECTICUT SCHOOL OF LAW

During the housing bubble, private-label securitization financed the majority of subprime and nontraditional mortgages. This system proceeded on the assumption that housing prices would keep going up. When housing prices fell and people could not refinance out of unaffordable loans, investors lost confidence in private-label mortgage securitization and the system collapsed in August 2007.

This statement begins with a thumbnail sketch of securitization. Then I describe the role played by securitization in the financial crisis. Following that, I analyze the inherent flaws in private-label mortgage securitization. The statement goes on to describe current conditions in that market. I close by describing needed reforms.

I. An Introduction to Securitization

Back in the 1970s, banks had to hold home mortgages in portfolio until those loans were paid off. This destabilized banks that made mortgages because they got their financing from demand deposits, but invested those deposits in illiquid mortgages. This “term mismatch” between assets and liabilities was a direct cause of the 1980s savings and loan crisis.

Starting in the late 1970s, securitization burst on the scene and eliminated the need for lenders to hold their mortgages in portfolio. The idea behind securitization is ingenious: bundle a lender’s loans, sell them to a bankruptcy-remote trust, repackage the monthly loan payments into bonds rated by rating agencies, back the bonds with the underlying mortgages as collateral, and sell those bonds to investors.

1 I use the term “nonprime” to refer to subprime loans plus other nontraditional mortgages. Subprime mortgages carry higher interest rates and fees and are designed for borrowers with impaired credit. Nontraditional mortgages encompass a variety of risky mortgage products, including option payment ARMs, interest-only mortgages, and reduced documentation loans. Originally, these nontraditional products were offered primarily in the “Alt-A” market to people with near-prime credit scores but intermittent or undocumented income sources. Eventually, interest-only ARMs and reduced documentation loans penetrated the subprime market as well.
Investment banks “structured” these securitization deals by dividing the bonds into “tranches” (French for “slice”). The best tranche, with the lowest expected default rate, carried an AAA rating, was paid off first, and offered the lowest rate of return. The lower tranches were rated AA, A, etc., down to the junior-most tranche, known as the equity tranche. The equity tranche was paid off last and was the first to absorb any losses from the loans.

Securitization was prized for accomplishing four things. First, lenders were able to get their mortgages off their books. Second, securitization appeared to manage the risks of mortgages by slicing and dicing those risks and spreading them among millions of investors with assorted tolerances for risk. Third, securitization opened up huge new pools of capital to finance home mortgages. Finally, securitization freed lenders from relying principally on insured deposits in order to make loans. Instead, in a continuous cycle, lenders could make loans, sell those loans through securitization, and then plow the proceeds into a new batch of loans, which in turn would be securitized. This paved the way for a new breed of nonbank subprime lenders, who had little in the way of capital reserves, were free from Federal banking regulation, and were inured to the reputational constraints of banks and thrifts.

At first, securitization was limited to prime loans, which were mostly securitized through the two Government-sponsored entities (GSEs) Fannie Mae and Freddie Mac. Once the market gained confidence about its ability to price subprime mortgages, securitization expanded to the subprime market in the early 1990s. Although the GSEs made limited forays into the subprime market and later expanded those forays around 2005, most subprime securitizations did not take place through the GSEs, but rather through the “private-label” securitization market. The private-label market lacked the same degree of public accountability that was expected of Fannie Mae and Freddie Mac as GSEs. By 2006, two-thirds or more of subprime mortgages were being securitized through the private-label market.

II. The Role of Securitization in the Financial Crisis
A. How Private-Label Securitization Increased the Risk of Mortgage Lending

Before securitization, lenders usually did it all: they solicited loan applicants, underwrote and funded the loans, serviced the loans, and held the loans in portfolio. Lenders earned profits on loans from interest payments as well as from upfront fees. If the loans went into default, the lenders bore the losses. Default was such a serious financial event that lenders took care when underwriting loans.

All that changed with private-label securitization. Securitization allowed lenders to offload most of the default risk associated with nonprime loans. Under the “originate-to-distribute” model, lenders could make loans intending to sell them to investors, knowing that investors would bear the financial brunt if the loans went belly-up. Similarly, securitization altered the compensation structure of nonprime lenders. Lenders made their money on upfront fees collected from borrowers and the cash proceeds from securitization offerings, not on the interest payments on loans.

Lenders liked the security of being paid in advance, instead of having to wait for uncertain monthly payments over the life of loans. And, because they could pass the lion’s share of the default risk onto faceless investors, lenders had less reason to...
care about how well their loans performed. In my examinations of internal records of major nonprime lenders, including Federal thrift institutions and national banks, too often I found two sets of underwriting standards: high standards for the loans they kept on their books and lax standards for the loans that they securitized.

At their peak, investment grade, nonprime residential mortgage-backed securities (RMBS) were considered excellent investments because they supposedly posed minimal default risk while offering high returns. Investors clamored for these bonds, creating demand for ever-riskier loans.

Lenders were not the only players in the chain between borrowers and investors. Investment banks played significant roles as underwriters of nonprime securitizations. Lehman Brothers, Bear Stearns, Merrill Lynch, JPMorgan, Morgan Stanley, Citigroup, and Goldman Sachs underwrote numerous private-label nonprime securitizations. From 2000 through 2002, when IPO offerings dried up during the 3-year bear market, RMBS and CDO deals stepped into the breach and became one of the hottest profit centers for investment banks.

Investment banks profited from nonprime underwriting by collecting a percentage of the sales proceeds, either in the form of discounts, concessions, or commissions. Once an offering was fully distributed, the underwriter collected its fee in full. This compensation system for the underwriters of subprime offerings caused Donna Tanoue, the former Chairman of the Federal Deposit Insurance Corporation, to warn: “[T]he underwriter’s motivation appears to be to receive the highest price . . . on behalf of the issuer—not to help curb predatory loans.”

Tanoue’s warning proved prophetic. In February 2008, Fitch Ratings projected that fully 48 percent of the subprime loans securitized by Wall Street in 2006 would go into default. Despite that dismal performance, 2006 produced record net earnings for Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns. That year, manager pay reflected the bottom-line importance that investment banks placed on private-label RMBS, with managing directors in the mortgage divisions of investment banks earning more on average in 2006 than their counterparts in other divisions.

B. How Securitization Fueled Contagion

Ultimately, private-label mortgage securitization turned out to be an edifice built on a rotting foundation. Once that foundation gave way, rising nonprime delinquencies mushroomed into international contagion for a number of reasons. For example, the same loan often served as collateral for multiple bonds, including an RMBS, a CDO, and a CDO of CDOs. If the loan went into default, it would jeopardize repayment for all three bonds. In addition, if defaults led to downgrades on those bonds, those assets were highly correlated. If rating agencies downgraded one issue, other issues came into question as well.

Collateral is another reason why nonprime loans infected other markets. Many large institutional investors bought nonprime bonds that they later pledged as security for other types of loans. Banks, for instance, pledged their nonprime bonds as security for short-term loans from other banks on the market for interbank credit. Major corporations borrowed money from other corporations on the short-term commercial paper market by issuing paper backed by nonprime bonds. As the value of nonprime bonds fell, lenders began calling loans and ultimately the interbank lending and asset-backed commercial paper markets slowed to a crawl.

Banks also reinjected themselves with subprime risks by buying private-label RMBS and CDOs and effectively taking those risks back on their books. When they sustained major losses on those bonds, they reined in their lending, adding fuel to the recession.

General investor panic is the final reason for contagion. Even in transactions involving no nonprime collateral, concerns about the nonprime crisis had a ripple effect, making it hard for companies and cities across-the-board to secure financing. Banks did not want to lend to other banks out of fear that undisclosed nonprime losses might be lurking on their books. Investors did not want to buy other types of securitized bonds, such as those backed by student loans or car loans, because they lost faith in ratings and could not assess the quality of the underlying collateral. Stocks in commercial banks, insurance companies, and Wall Street firms took a beating because investors did not know where nonprime assets were hidden and feared more nonprime write-downs. Because they did not know exactly who was tainted by nonprime, investors stopped trusting practically everyone.

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2The top four ratings issued by a rating agency are “investment grade” ratings. For Standard & Poor’s, these are ratings of AAA, AA, A, and BBB; for Moody’s, Aaa, Aa, A, and Baa. Any rating below investment grade is considered junk bond status.
III. Inherent Flaws in Private-Label Mortgage Securitization

A. The Lemons Problem

In hindsight, private-label mortgage securitization turned out to resemble the used car business in one respect. Both businesses have motivations to sell “lemons.” In other words, they have structural incentives to sell products carrying hidden defects and a heightened risk of failure.

There are two main reasons for this lemons problem. First, securitization resulted in a misalignment of compensation and risk. Each company in the securitization process was able to collect upfront fees, while shifting default risk to downstream purchasers. Although investors tried to protect themselves through recourse clauses and structures making lenders retain the equity tranches, those contractual safeguards often broke down. Lenders were able to hedge their equity tranches or shed them by resecuritizing them as CDOs. Similarly, too many originators lacked the capital to honor their recourse obligations in full.

Second, securitization fueled a relentless demand for volume and volume-based commissions. In the process, the quest for volume pushed lending standards steadily downward in order to maintain market share. This became a challenge in 2003, when interest rates began rising again, ending the refinancing boom. Securitizers needed another source of mortgages in order to increase the rate of securitization and the fees it generated. The “solution” was to expand the market through non-traditional mortgages, especially interest-only loans and option payment ARMs offering negative amortization. Lenders also relaxed their underwriting standards on traditional products to qualify more borrowers. This expansion of credit swept a larger portion of the population into the potential homeowner pool, driving up housing demand and prices, and consumer indebtedness. Many big investment banks, including Lehman Brothers and Bear Stearns, went so far as to buy subprime lenders in order to have an assured pipeline of mortgages to securitize.

In short, the incentive structure of securitization caused the lemons problem to grow worse over time. Not only did private-label securitization sell lemons, those lemons grew more rotten as the housing bubble grew. In the process, securitization actors played the ends against the middle, injuring borrowers and investors alike.

B. Harm to Borrowers

Private-label securitization hurt numerous borrowers. First, investor appetite for high-yield RMBS caused originators to peddle risky mortgages, to the exclusion of safer loans. Second, compensation methods such as yield spread premiums saddled many borrowers with costlier mortgages than they qualified for. Third, borrowers whose loans were securitized lost important legal rights without their consent.

On the first point: As mentioned above, in order to maintain volume while satisfying investor demand for high-yield bonds, investment banks and lenders had to continually tap new groups of borrowers with lower credit scores and less disposable income. For many of these cash-strapped borrowers, low monthly payments were a primary consideration. In order to offer the lure of lower initial payments, lenders concocted bafflingly complex loans combining a host of risky features, including adjustable-rate terms, teaser rates, high margins, stiff prepayment penalties, and no amortization or even negative amortization. Evidence is now coming to light that investment banks or large investors in many cases dictated those underwriting guidelines to originators.

The front-end payments of these hazardous mortgages were attractive to unsuspecting borrowers and usually lower than the payments on a plain vanilla fixed-rate mortgage. But the back-end risks of those mortgages were daunting, yet difficult or impossible for borrowers to discern. Worse yet, to qualify individual borrowers, lenders often threw full income verification out the window.

There was a second way in which investor demand for higher yield hurt many borrowers. Because investors paid more for higher yields, lenders offered mortgage brokers higher compensation in the form of yield spread premiums to convince borrowers who probably qualified for cheaper loans to unwittingly pay higher interest rates. The Wall Street Journal estimated that by year-end 2006, 61 percent of subprime mortgages went to borrowers with high enough credit scores to qualify for cheaper prime loans. Yield spread premiums artificially inflated the interest rates that borrowers had to pay, substantially increasing the likelihood that nonprime loans would default and go into foreclosure. Economists have estimated the size of...
this risk. For every 1 percent increase in the initial interest rate of a home mortgage, the chance that a household will lose its home rises by 16 percent a year.

Finally, under the Uniform Commercial Code in many States, borrowers whose loans are securitized lose valuable legal rights without their consent or financial compensation. This doctrine, known as the “holder-in-due-course rule,” prohibits borrowers whose loans are securitized from raising common types of fraud or other misconduct in the making of their loans against all subsequent purchasers of their loan notes. In many case, this shields investment banks, rating agencies, and investors from borrower suits for fraud. Although borrowers can still raise fraud as a claim or defense against their mortgage brokers and lenders, many of those entities are bankrupt today and thus judgment-proof. More importantly, once a loan is securitized, any suit for foreclosure will be brought by the investor or securitized trust, not the mortgage broker or lender. In those cases, the holder-in-due course rule prevents borrowers who were defrauded from even raising the fraud as a defense to foreclosure.

C. Harm to Investors

The lack of transparency in securitization also hurt investors. The securities disclosures for private-label RMBS lacked crucial information to investors. In addition, product complexity made it difficult or impossible for investors to grasp the risks associated with many offerings. Finally, both problems caused investors to place undue reliance on credit ratings, which proved to be badly inflated.

1. Inadequate Securities Disclosures—For most of the housing bubble, the Securities and Exchange Commission (SEC) had no rule requiring disclosures specifically tailored to RMBS or CDOs. The SEC adopted Regulation AB in an attempt to address that gap, but the rule did not go into effect until January 1, 2006, too late to cover earlier private-label offerings.

Once the rule went into effect, it was riddled with holes. First, Reg AB only applies to public offerings of asset-backed securities. An investment bank could simply bypass Reg AB by structuring the offering as a private offering limited to big institutional investors. In private offerings, SEC disclosures are lighter or left to private negotiation, based on the idea that institutional investors have clout to demand the information they need. Wall Street took full advantage of this loophole, meaning that CDOs were almost always sold through private offerings with seriously deficient disclosures.

Even when Reg AB did apply—i.e., in public offerings of asset-backed securities—the disclosures were too skimpy to be of use. The SEC modeled many of Reg AB’s disclosures on the reporting requirements for corporate issuers. Corporations usually have track records to speak of, so securities disclosures for those issuers focus on recent past performance. But past performance was irrelevant for most offerings of RMBS and CDOs, which involved relatively new mortgages. In essence, Reg AB puts the wrong information under the microscope.

Instead, investors in nonprime bonds needed standardized information on the risk characteristics of the individual loans in the loan pool. But Reg AB does not require that level of detail. While the rule encouraged investment banks to make tapes with loan level data available to investors online, it did not force them to do so. Instead, Reg AB simply mandates a summary of the aggregate characteristics of the loan pool. That made it difficult to discern whether the riskiest loans were going to the strongest borrowers or to the worst borrowers in the loan pool.

Similarly, too many prospectuses and offering memoranda for private-label offerings stated that the lenders reserved the right to make exceptions to their underwriting standards in individual cases. In 2006 and 2007, there were offerings in which the exceptions—in other words, loans that flunked the lender’s underwriting standards—outweighed the number of loans that conformed to the lender’s stated standards. The exact (and often high) percentage of exceptions was not disclosed to investors.

Nor does Reg AB make investment banks disclose the due diligence reports they commissioned from outside firms, even when those reports contained evidence of deteriorating lending standards. Too often, investment banks withheld those reports from investors and ratings agencies.

Reg AB is also deficient regarding the performance of individual loans. While Reg AB requires some reporting on loan performance, it is only for the first year following the offering, not for the life of the loans.

All told, there was a dearth of useful publicly available information on the loan pools underlying private-label RMBS and CDOs. The SEC disclosure scheme for nonprime RMBS and CDOs was so misbegotten and riddled with exceptions that those securities operated in a fact-free zone. Investors and analysts who wanted to do serious due diligence could not get the facts they needed to figure out the true
risk presented by the loans. Without those facts, investors often overpaid for those securities. Furthermore, the dearth of key public information also impeded the development of a healthy resale market in those bonds, which became a big problem later on when banks tried to unload toxic subprime assets off their books.

2. Complex Products—Many private-label RMBS and CDOs were so complex that due diligence was too costly or impossible for investors. CDOs are a good example. Typically, a CDO consisted of junior tranches of RMBS from different offerings, sometimes paired with other types of asset-backed securities involving receivables from things like credit cards or auto loans. At best, the investor received data on the quality of the underlying bonds. But it was impossible for the investor to x-ray the offering in order to analyze the underlying home mortgages, credit card borrowers, or auto loans themselves. That was even more impossible when the CDO was a “synthetic CDO” made up of credit default swaps on RMBS and asset-backed securities.

Even in regular RMBS, complexity was a big problem. One issue was the sheer number of tranches. Another was the fact that many private-label RMBS offerings featured complex credit enhancement rules about who would receive cash flows from the mortgages in what amounts, depending on changes in the amount of subordination or overcollateralization. This meant that investors could not just stop with estimating expected losses from the mortgages. They also had to analyze who would get what cash flows when, based on a changing kaleidoscope of scenarios.4 In addition, too many offerings were made on a “to be announced” or “TBA” basis, which meant that investors could not scrutinize the underlying loans because the loans had not yet been put in the loan pool. Finally, many securitization deals involved custom features that undermined standardization.

Of course, this discussion begs the question whether investors would have done adequate investigation in any case when the housing bubble was at its height and euphoria prevailed. But back then, even investors who wanted to do serious due diligence would have met insuperable obstacles. More recently, lack of transparency and complexity have blocked the formation of an active, liquid resale market that would enable banks to remove impaired RMBS and CDOs from their books.

3. Overreliance on Credit Ratings—Poor disclosures and overly complex deals caused investors to over rely on credit ratings. Meanwhile, the rating agencies had financial incentives to understate the risks of nonprime RMBS and CDOs. The investment banks that underwrote nonprime securitizations paid the rating agencies to provide them with investment-grade ratings. The rating agencies touted the top-rated nonprime bonds—ranging from AAA down to A—as hardly ever defaulting.

Under banking and insurance laws, banks and insurance companies can only invest in types of bonds permitted by law. Private-label RMBS and CDOs carrying investment grade ratings are on the permissible list, so long as those ratings are rendered by rating agencies designated Nationally Recognized Statistical Rating Organizations (NRSROs) by the SEC. These regulatory rules encouraged institutional investors in search of higher yields to buy the top-rated nonprime RMBS and CDOs.

During the housing bubble, rating fees on private-label RMBS and CDOs were the fastest-growing sector of the rating agency business. Issuers paid the rating agencies handsome fees from these deals, spurring the rating agencies to rate offerings for which there was scant historical default data. Similarly, the rating agencies used flawed models which assumed never-ending housing price appreciation and were not updated with new default data. Nor did most investors realize that an AAA rating for an RMBS offering was different than, and inferior to, an AAA rating for a corporate bond.5

D. Impediments to Loan Modifications

Deal provisions in private-label securitizations have also paralyzed constructive workouts of many distressed home loans. Today, securitized trusts, not lenders, hold the vast majority of those loans. The complexity of the securitized deals often pits servicers against investors and investors against each other. Too often, the servicers opt for foreclosing on property, instead of arranging workouts that would allow homeowners to stay in their homes. The irony of this approach is that, in many cases, workouts in the form of loan forbearance or loan modifications would result in a higher recovery.

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5In large part, and in contrast with corporate bonds, this is because downgrades of a tranched RMBS tend to make downgrades of other RMBS tranches more likely. Fender and Mitchell, supra note 4, at 33.
There are several explanations for this seemingly irrational behavior, including inadequate staffing levels and compensation clauses that cause servicers to earn more money from foreclosures than workouts. But the main reason why more workouts do not occur is that many pooling and servicing agreements place constraints on servicers’ ability to negotiate loan workouts. Some limit the percent of the loan pool that can be modified. Others have vague prohibitions allowing modifications only to the extent they are in the best interests of the investors. Even when those agreements give servicers latitude to modify loans, servicers are reluctant to modify loans because they fear lawsuits by warring trancheholders for breach of fiduciary duty. This hold-up problem has stymied Federal regulators’ attempts to speed up loan modifications and halt the vicious cycle of falling home prices. With no Federal legislation to force modifications, regulators have only had limited success. Meanwhile, loan workouts are crawling at a snail’s pace, leading foreclosed homes to be dumped on the market in record numbers and pushing home prices further down in the process.

IV. Current Conditions in the Private-Label Securitization Markets

Due to the problems just described, the markets for private-label RMBS and CDOs are essentially dead. The securitization markets for auto loans, credit cards, and student loans are open, but their volume has dropped sharply due to general concerns about the soundness of the securitization process. For all intents and purposes, the Federal Government has become the financier of first resort for residential mortgages. In 2008, agency mortgage-backed securities—in other words, RMBS issued by Fannie Mae, Freddie Mac, and Ginnie Mae (FHA loans)—accounted for over 96 percent of the U.S. RMBS market. Private-label mortgage-backed securitization accounted for less than 4 percent of the market that year.

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According to the Securities Industry and Financial Markets Association (SIFMA), the “private label market remains dormant due to re-REMICs of old loans that were repackaged into tranches of good and bad loans. This disparity widened in the first 6 months of 2009, when the relative market shares of agency and private-label mortgage-backed securitization were 99 percent and 1 percent. In second quarter 2009, moreover, 38.4 percent of private-label RMBS transactions were re-REMICs of old loans that were repackaged into tranches of good and bad loans. According to the Securities Industry and Financial Markets Association (SIFMA), the “private label market remains dormant due to re-

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6 I use the term “agency” to refer to GNMA, Fannie Mae and Freddie Mac mortgage-backed securities and collateralized mortgage obligations. The term “private-label” includes RMBS and CMOs.
duced lending, lack of investor demand, low liquidity,” and rising delinquencies and foreclosures. 7

As these numbers suggest, private investors are largely shunning the private-label mortgage securitization market in favor of other investments, including agency RMBS. In the meantime, the Federal Reserve has become a major investor in agency RMBS, having begun purchases in this market in December 2008. The Fed has pledged to buying up to $1.25 trillion in agency RMBS before the end of this year, in an effort to help lower home mortgage interest rates.

Other securitization markets associated by investors with mortgages are also dormant. SIFMA reports that the private-label commercial MBS primary market “remains closed.”8 Similarly, global issuance of CDOs has essentially come to a halt.

Outside of the mortgage sector, auto loan, credit card, and student loan securitizations have fallen by over half since 2007. All three sectors became paralyzed in mid-2008, prompting the Federal Reserve to revive these markets with the Term Asset-Backed Securities Lending Facility (TALF). Spreads soared in 2008 and have since fallen, although have not completely recovered. This suggests that investor concerns about the general integrity of the securitization process spilled over to other sectors.

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8Id. at 9.
Although TALF has helped to revive these markets, particularly in the auto and credit card areas, delinquencies and charge-offs continue to climb.

V. Needed Reforms

Private-label mortgage securitization will undoubtedly return in one form or another. And just as certainly, investors will eventually forget the lessons from this crisis. To avoid repeating the mistakes of the past, it is essential to put private-label mortgage securitization on sound footing going forward.

A. Proposals To Realign Incentives

Discussions about reforming private-label securitization often revolve around proposals to realign the incentives of originators and investment banks. The idea is to give them sufficient "skin in the game" to care about soundly underwritten loans. Thus, the Obama Administration has proposed requiring securitizers to retain at least 5 percent of the credit risk on each asset in the asset-backed securities that they issue. Securitizers would also be barred from resecuritizing or hedging that retained risk. Section 213 of the Mortgage Reform and Anti-Predatory Lending Act, H.R. 1728, passed by the House of Representatives on May 7, 2009, contains a similar proposal.

There are other incentive-based proposals to improve loan underwriting. One involves increased capital: in other words, requiring commercial and investment banks—especially too-big-to-fail banks—to hold more capital, both against the tranches they retain and against other aspects of securitization that could come back to haunt them, such as recourse clauses and structured investment vehicles.

Another proposal is to realign originators' compensation with loan performance. Accounting standards could be changed to eliminate immediate recognition of gain on sale by originators at the time of securitization. And there are two promising proposals to curb reckless originations by independent mortgage brokers. One would prohibit pay incentives such as yield spread premiums for steering customers to costlier or riskier loans. H.R. 1728, §103. Another proposal would make full payout of compensation to mortgage brokers contingent on good performance of the loan.

A final idea along these lines is to require lenders and securitizers to make stronger representations and warranties to investors, accompanied by stiffer recourse provisions for loans that violate those reps and warranties. The American Securitization Forum has advanced this reform.

All of these proposals are good ideas. However, they are not enough, together or alone, to ensure sound underwriting. Take the risk retention requirement, for example. It is doubtful whether the ban on hedging is even enforceable, since "sometimes firms pool their risk and set hedges against several positions at once." More importantly, requiring risk retention does not solve the fact that banks, once they got loans off of their books through securitization, assumed that risk again by investing in toxic subprime RMBS and CDOs.

As for capital requirements, more capital is essential for depository institutions and investment banks. But capital is no panacea. Banks have proven adept at evading minimum capital requirements. Furthermore, the credit crisis raised serious concerns about the newly adopted Basel II capital standards, which were designed to lower capital and allow large internationally active banks—i.e., too-big-to-fail banks—to set their own minimum capital.

Stronger reps and warranties, backed by stiffer recourse, are likewise advisable. But the crisis has shown that recourse provisions are only as good as a lender’s solvency. As the credit crisis began, most nonbank subprime lenders have gone out of business. In addition, 126 banks and thrifts have failed since 2007. Some institutions failed precisely due to their inability to meet investor demands for recourse.

Even when recourse can be had, negotiations can be long and drawn-out. Moreover, if a recourse provision is not ironclad, a solvent lender may be able to escape it. For example, any provisions that would condition recourse on the lender’s knowledge that the reps and warranties were violated—creating a Sergeant Schultz "I know nothing" defense—usually would be meaningless if the misconduct in question was committed by an independent mortgage broker. That would include situations
where the lender failed to adequately supervise the broker, which often was the case.

For all of these reasons, having “skin in the game” is not enough to ensure sound loan underwriting. As discussed below, more is needed in the form of minimum underwriting standards.

B. Improved Due Diligence by Investors

Meanwhile, investors need the ability to do better due diligence. Three major reforms are needed to provide investors with the information that they need to make sound investment decisions about private-label mortgage-related bonds. First is improved transparency, second is product simplification and standardization, and third is rating agency reform.

Transparency — The SEC should require securitizers to provide investors with all of the loan-level data they need to assess the risks involved. See Obama Administration Proposal, Title IX, § 952. In addition, the SEC should require securitizers and servicers to provide loan-level information on a monthly basis on the performance of each loan and the incidence of loan modifications and recourse. These disclosures should be made in public offerings and private placements alike. In addition, TBA offerings should be prohibited because it is impossible for investors to do due diligence on those loan pools.

Product Simplification and Standardization — The Government should encourage simpler, standardized securitization products, whether through the REMIC tax rules or rules governing permissible investments by insured banks and thrifts. Similarly, the Government should explore ways to build a liquid secondary trading market in private-label RMBS and other bonds.

Rating Agency Reform — The most critical rating agency reform is banning the “issuer pays” system, in which issuers pay for ratings. That would help ensure that rating agencies serve the interests of investors, not issuers. In addition, it is necessary to require the rating agencies to create a new, different ratings scale for mortgage structured finance to distinguish it from the ratings for corporate bonds. Finally, NRSRO designations need to be abolished.

The Obama Administration’s proposal takes a different approach. The proposal would subject NRSROs to enhanced SEC oversight, including expanded public disclosures. In addition, the Administration would require rating agencies to have systems to “manage, and disclose” their conflicts of interest. Title IX, subtitle C.

While better investor due diligence is necessary to improve private-label mortgage securitization, it is not enough. At the height of every business cycle, memories grow dim and euphoria takes hold. During bubbles, when default rates are low, investors are apt to cast aside basic due diligence precautions to grab the chance of a high-yield investment. This temptation is particularly great for institutional money managers, who have cash they need to put to work and face pressure to report the same high returns as their competitors. For all of these reasons, minimum Federal underwriting standards are a needed supplement to investor due diligence.

C. Protecting Borrowers and the Financial System

We cannot assume that investors will monitor adequately or that standardization will be achieved. Furthermore, none of the measures outlined above addresses the obstacles to loan modifications. Two additional measures are needed to protect borrowers and the larger economic system from reckless loans and unnecessary foreclosures.

1. Uniform Minimum Underwriting Standards Enforceable by Borrowers — The downward spiral in underwriting standards drove home the need for uniform consumer protection standards that apply to all financial services providers. In fact, a new study by the Center for Community Capital at the University of North Carolina (Chapel Hill) finds that States that mandated strong loan underwriting standards had lower foreclosure rates than States without those laws. 13

The Federal Reserve’s 2008 rule for higher-cost loans accomplished part of this goal, but all loans need protection, not just subprime loans. The Obama Administration proposal, H.R. 1728, and H.R. 3126 would solve this problem by creating one set of uniform Federal laws that apply to all financial services providers across the country, regardless of entity, charter, or geographic location. To prevent a race to the bottom in which regulators compete to relax lending standards, the Administra-

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14Federal Reserve System, Truth in Lending: Final rule; official staff commentary, 73 FED. REG. 44522, 44536 (July 30, 2008). The Board intended to cover the subprime market, but not the prime market. See, id. at 44536-37.
tion proposal and H.R. 3126 would consolidate the authority to administer those laws in a new Consumer Financial Protection Agency. Under both, the standards would constitute a floor, in which weaker State laws are federally preempted. States would remain free to enact stricter consumer protections so long as those protections were consistent with Federal law.

These Federal standards do three things. First, the standards would ensure proper loan underwriting based on the consumer’s ability to repay. Second, the standards would prohibit unfair or deceptive practices in consumer credit products and transactions. Finally, the standards would promote transparency through improved consumer disclosures. Bottom-line, the proposed standards would help make it possible for consumers to engage in meaningful comparison shopping, with no hidden surprises.

In the event these standards are violated, injured borrowers need an affirmative claim for relief as well as a defense to foreclosure. Both the claim and the defense should be available against loan originators. Limiting relief to loan originators does not help borrowers with securitized loans, however, if their loans later go into foreclosure or their originators become judgment-proof. When a securitized loan is foreclosed on, for example, the lender is not the plaintiff; rather, foreclosure is instituted by the servicer, the owner of the loan, or its designee (generally the Mortgage Electronic Registration Systems or MERS). Consequently, fairness requires allowing injured borrowers to raise violations as a defense to foreclosure against those entities. Similarly, giving borrowers an affirmative claim against assignees for violations of Federal standards by originators will spur investors and investment banks to insist on proper underwriting of loans and afford injured borrowers relief when their originators are judgment-proof or a securitized trust sues for foreclosure. The Administration’s proposal and H.R. 1728, §204, both contain assignee liability provisions designed to accomplish these objectives.

Some fear that a borrower right of action against securitized trusts and investment banks would reduce access to credit. A 2008 study by Dr. Raphael Bostic et al. examined that question by looking at the effect of assignee liability provisions in nine State antipredatory lending laws on the availability of subprime credit. The study found “no definitive effect of assignee liability on the likelihood of subprime originations, even when the [assignee] liability provisions are in their strongest form.” Subprime originations rose in six of the nine States studied that had assignee liability, relative to the control State. Results were mixed in the other three States, depending on how subprime lending was defined. No State reported a consistent drop in subprime originations.15

In short, assignee liability is not likely to impede access to credit. To the contrary, borrower relief will provide needed incentives for originators, Wall Street, and investors to only securitize loans that borrowers can repay. Providing that relief would go a long way toward avoiding the biggest threat to access to credit, which is a repeat collapse of private-label securitization.

2. Remove Artificial Barriers to Cost-Effective Loan Modifications—Right now, too many distressed loans are needlessly going to foreclosure despite the availability of cost-effective loan modifications. Not only do these foreclosures oust homeowners from their homes, they needlessly depress home values for everyone else. It is time to cut this Gordian knot.

Most securitized loan pools are created as “Real Estate Mortgage Investment Conduits,” or REMICs, under the Federal tax code. Any securitization vehicle that qualifies for REMIC treatment is exempt from Federal income taxes. Congress or the Internal Revenue Service should amend the REMIC rules to disqualify future mortgage pools from favored REMIC tax treatment unless pooling and servicing agreements and related deal documents are drafted to give servicers ironclad incentives to participate in large-scale loan modifications when specific triggers are hit.16

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16See, Michael S. Barr and James A. Feldman, Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages (Center for American Progress April 2008).
On behalf of the American Securitization Forum, I appreciate the opportunity to testify before this Subcommittee as it explores problems and solutions associated with the securitization process.

The American Securitization Forum (ASF) is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 350 firms, including investors, mortgage and consumer credit lenders and securitization issuers, financial intermediaries, legal and accounting firms, and other professional organizations involved in the securitization markets. The ASF also provides information, education, and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. ASF is an affiliate of the Securities Industry and Financial Markets Association.1

My testimony today will address the following topics:

1. The role and importance of securitization to the financial system and U.S. economy;
2. Current conditions in the securitization market;
3. Limitations and deficiencies in securitization revealed by the recent financial market crisis; and
4. Views on certain securitization policy and market reform initiatives now underway or under consideration.

I. The Role and Importance of Securitization to the Financial System and U.S. Economy

Securitization—generally speaking, the process of pooling and financing consumer and business assets in the capital markets by issuing securities, the payment on which depends primarily on the performance of those underlying assets—plays an essential role in the financial system and the broader U.S. economy. Over the past 25 years, securitization has grown from a relatively small and unknown segment of the financial markets to a mainstream source of credit and financing for individuals and businesses alike.

In recent years, the role that securitization has assumed in providing both consumers and businesses with credit is striking: currently, there is over $12 trillion of outstanding securitized assets,2 including mortgage-backed securities (MBS), asset-backed securities (ABS), and asset-backed commercial paper. This represents a market nearly double the size of all outstanding marketable U.S. Treasury securities—bonds, bills, notes, and TIPS combined.3 Between 1990 and 2006, issuance of mortgage-backed securities grew at an annually compounded rate of 13 percent, from $259 billion to $2 trillion a year.4 In the same time period, issuance of asset-backed securities secured by auto loans, credit cards, home equity loans, equipment loans, student loans and other assets, grew from $43 billion to $753 billion.5 In 2006, just before the downturn, nearly $2.9 trillion in mortgage- and asset-backed securities were issued. As these data demonstrate, securitization is clearly an important sector of today's financial markets.

The importance of securitization becomes more evident by observing the significant proportion of consumer credit it has financed in the U.S. It is estimated that securitization has funded between 30 and 75 percent of lending in various markets, including an estimated 59 percent of outstanding home mortgages.6

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plays a critical role in nonmortgage consumer credit as well. Historically, most banks have securitized 50–60 percent of their credit card assets.\(^7\) Meanwhile, in the auto industry, a substantial portion of automobile sales are financed through auto ABS.\(^8\) Overall, recent data collected by the Federal Reserve Board show that securitization has provided over 25 percent of outstanding U.S. consumer credit.\(^9\) In the first half of 2009 alone, securitization financed over $9.5 billion in student loans.\(^10\) Securitization also provides an important source of commercial mortgage loan financing throughout the U.S., through the issuance of commercial mortgage-backed securities.

Over the years, securitization has grown in large measure because of the benefits and value it delivers to transaction participants and to the financial system. Among these benefits and value are the following:

1. **Efficiency and Cost of Financing.** By linking financing terms to the performance of a discrete asset or pool of assets, rather than to the future profitability or claims-paying potential of an operating company, securitization often provides a cheaper and more efficient form of financing than other types of equity or debt financing.

2. **Incremental Credit Creation.** By enabling capital to be recycled via securitization, lenders can obtain additional funding from the capital markets that can be used to support incremental credit creation. In contrast, loans that are made and held in a financial institution’s portfolio occupy that capital until the loans are repaid.

3. **Credit Cost Reduction.** The economic efficiencies and increased liquidity available from securitization can serve to lower the cost of credit to consumers. Several academic studies have demonstrated this result. A recent study by National Economic Research Associates, Inc., concluded that securitization lowers the cost of consumer credit, reducing yield spreads across a range of products including residential mortgages, credit card receivables and automobile loans.\(^11\)

4. **Liquidity Creation.** Securitization often offers issuers an alternative and cheaper form of financing than is available from traditional bank lending, or debt or equity financing. As a result, securitization serves as an alternative and complementary form of liquidity creation within the capital markets and primary lending markets.

5. **Risk Transfer.** Securitization allows entities that originate credit risk to transfer that risk to other parties throughout the financial markets, thereby allocating that risk to parties willing to assume it.

6. **Customized Financing and Investment Products.** Securitization technology allows for precise and customized creation of financing and investment products tailored to the specific needs of issuers and investors. For example, issuers can tailor securitization structures to meet their capital needs and preferences and diversify their sources of financing and liquidity. Investors can tailor securitized products to meet their specific credit, duration, diversification and other investment objectives.\(^12\)

Recognizing these and other benefits, policymakers globally have taken steps to help encourage and facilitate the recovery of securitization activity. The G-7 finance ministers, representing the world’s largest economies, declared that “the current situation calls for urgent and exceptional action . . . to restart the secondary markets for mortgages and other securitized assets.”\(^13\) The Department of the Treasury stated in March that “while the intricacies of secondary markets and securitization . . .

\(^7\) Ibid., p. 10.  
\(^8\) Ibid., p. 10.  
\(^12\) The vast majority of investors in the securitization market are institutional investors, including banks, insurance companies, mutual funds, money market funds, pension funds, hedge funds and other large pools of capital. Although these direct market participants are institutions, many of them—pension funds, mutual funds and insurance companies, in particular—invest on behalf of individuals, in addition to other account holders.  
may be complex, these loans account for almost half of the credit going to Main Street,"14 underscoring the critical nature of securitization in today’s economy. The Chairman of the Federal Reserve Board recently noted that securitization “provides originators much wider sources of funding than they could obtain through traditional sources, such as retail deposits” and also that “it substantially reduces the originator’s exposure to interest rate, credit, prepayment, and other risks.”15 Echoing that statement, Federal Reserve Board Governor Elizabeth Duke recently stated that the “financial system has become dependent upon securitization as an important intermediation tool,”16 and last week the International Monetary Fund (IMF) noted in its Global Financial Stability Report that “restoring private-label securitization markets, especially in the United States, is critical to limiting the fallout from the credit crisis and to the withdrawal of central bank and Government interventions.”17 There is clear recognition in the official sector of the importance of the securitization process and the access to financing that it provides lenders, and of its importance to the availability of credit that ultimately flows to consumers, businesses, and the real economy.

Restoration of function and confidence to the securitization markets is a particularly urgent need, in light of capital and liquidity constraints currently confronting financial institutions and markets globally. As mentioned above, at present nearly $12 trillion in U.S. assets are funded via securitization. With the process of bank de-leveraging and balance sheet reduction still underway, and with increased bank capital requirements on the horizon, the funding capacity provided by securitization cannot be replaced with deposit-based financing alone in the current or foreseeable economic environment. Just last week, the IMF estimated that a financing “gap” of $440 billion will exist between total U.S. credit capacity available for the non-financial sector and U.S. total credit demand from that sector for the year 2009.18 Moreover, nonbank finance companies, who have played an important role in providing financing to consumers and small businesses, are particularly reliant on securitization to fund their lending activities, since they do not have access to deposit-based funding. Small businesses, who employ approximately 50 percent of the Nation’s workforce, depend on securitization to supply credit that is used to pay employees, finance inventory and investment, and other business purposes. Furthermore, many jobs are made possible by securitization. For example, a lack of financing for mortgages hampers the housing industry; likewise, constriction of trade receivable financing can adversely affect employment opportunities in the manufacturing sector. To jump start the engine of growth and jobs, securitization is needed to help restore credit availability.

Simply put, the absence of a properly functioning securitization market, and the funding and liquidity this market has historically provided, adversely impacts consumers, businesses, financial markets, and the broader economy. The recovery and restoration of confidence in securitization is therefore a necessary ingredient for economic growth to resume, and for that growth to continue on a sustained basis into the future.

II. Current Conditions in the Securitization Market

The U.S. securitization markets experienced substantial dislocation during the recent financial market turmoil, with a virtual collapse of both supply and demand in the new-issue market, very substantial reductions in liquidity, widespread declines in securities prices and valuations, and increases in risk premiums throughout the secondary market. While there have been signs of recovery in certain parts of the securitization market throughout the first three calendar quarters of 2009, some market segments—most notably, private-label residential mortgage backed securities—remain dormant, with other securitization asset classes and market sectors remaining significantly challenged.

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In the asset-backed securities market, total issuance volume remains at a relatively low level, with 2009 issuance projected to reach $130 billion, roughly in line with the $140 billion issued in 2008 but sharply down from the $750 billion issued in 2006.\(^{19}\) Although issuance rates in nearly all major asset classes, including credit cards, auto and equipment loans, and student loans, picked up in the second quarter of 2009, a recent ASF survey showed that market participants expect securitization issuance rates to return to only half of their predownturn levels over the next 2 to 3 years. For residential mortgage-backed securities, 2009 to date has seen over $1.2 trillion in issuance, compared with a yearlong total of $1.3 trillion in 2008 and $2.1 trillion in 2006. However, in 2009, less than 1 percent of this has been issued without a Government or GSE guarantee (i.e., private-label MBS); this is compared with private-label MBS comprising over 23 percent of all issuance during the time period from 1996 to 2006.\(^{20}\) Furthermore, private-label MBS transactions that have occurred in 2009 involved pools of seasoned, conforming loans—no major private-label residential mortgage-backed securities deal of which we are aware has directly financed new mortgage loan origination this year.

Part of the reason for this involves a broad retreat from risk by many investors. The events of 2007 and 2008, especially in the RMBS markets, resulted in significant loss experiences for many investors. While it seems unlikely that some types of investors, such as those who purchased securitized instruments issued by structured investment vehicles (SIVs) or certain types of collateralized debt obligations (CDOs), will play a significant role in the future MBS and ABS markets, the number of traditional securitization investors has also diminished, and along with it, the liquidity they have provided to both senior and subordinate parts of the market. Replacing at least a portion of this investor base is a significant challenge faced by participants in today’s market.

Certain programs sponsored by the Federal Government—in particular, the TALF program—have been successful in stimulating parts of the new-issue securitization market. President Obama described TALF as the Government’s “largest effort ever to help provide auto loans, college loans, and small business loans to the consumers and entrepreneurs who keep this economy running.”\(^{21}\) and in many ways, TALF is among the most successful of the Government's efforts to bolster the consumer economy. As of September 2009, TALF has directly financed $46 billion\(^{22}\) of ABS issuances out of the approximately $80 billion of ABS eligible for TALF that has been issued since March.\(^{23}\) Due in significant measure to TALF, credit costs on consumer ABS have, across the board, returned to levels more in line with their historical trends than the extremely high levels that were seen in late 2008 and early 2009. For example, 3-year AAA credit card spreads to benchmark rates had ballooned to more than 15 percent above LIBOR, but have since come

\(^{19}\)SIFMA, “U.S. ABS Issuance”, \url{http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USABSIssuance.pdf}.


\(^{22}\)SIFMA, “TALF”, \url{http://www.sifma.org/research/research.aspx?ID=10256#TALF}.


\(^{24}\)JPMorgan’s $2.53 billion credit card ABS deal, (Sept. 2009) \url{http://online.wsj.com/article/SB1253114742043716.html}.

back in to lower levels. The subordinate ABS markets are still relatively dormant, and unless banks are able to finance a greater portion of the capital structure, credit origination via securitization cannot be fully restored.

Notwithstanding the success of the TALF program and the restoration of a modest degree of securitization financing and liquidity in some market segments, significant challenges remain, including establishing a stable, sustainable, and broad-based platform for future securitization market issuance and investment activity that is less reliant on direct Government support.

III. Limitations and Deficiencies in Securitization Revealed by the Recent Financial Market Crisis

The recent financial market crisis revealed several limitations and weaknesses in securitization market activity. Among the multiple (and, in many cases, interrelated) deficiencies revealed were the following:

1. **Risk management failures, including the excessive or imprudent use of leverage and mismanagement of liquidity risk.** Many market participants—including financial intermediaries, investors, and others—established large, leveraged risk positions in securitized instruments. A significant number of these market positions were, in effect, highly levered triggers which, when tripped by an adverse rating action or downward price movement, caused widespread deleveraging and further price reductions. At the same time, large parts of the securitization market became reliant on cheap, short term liquidity to finance long-term assets. When this liquidity disappeared and financing was either repriced or withdrawn completely, a more systematic deleveraging and unwinding process ensued.

2. **Credit ratings methodologies and assessments that proved to be overly optimistic, and excessive reliance on credit ratings.** Especially in parts of the residential mortgage market, a favorable economic environment and persistent increase in housing prices masked gaps in credit rating agency models and methodologies that did not sufficiently factor in the risk of nationwide housing price declines and a high correlation in the performance of the assets underlying certain mortgage and asset-backed securities. At the same time, market participants became overly reliant on credit ratings, and many failed to perform or to act upon their own assessment of the risks created by certain securitized transaction structures.

3. **Deteriorating underwriting standards and loan quality.** Underwriting standards declined precipitously throughout various segments of the credit markets, including but not limited to subprime mortgages, with housing prices rising steeply and credit and liquidity in plentiful supply. As loan demand and competition among lending institutions intensified, asset quality declined, leaving securitized instruments vulnerable to credit-related performance impairments.

4. **Gaps in data integrity, reliability and standardization.** Especially in parts of the residential mortgage market, a combination of explosive lending growth, operational weaknesses, the absence of standardized and comparable loan-level data, an increasing prevalence of fraud and other factors caused investors broadly to question the accuracy and integrity of performance data relating to the assets underlying securitizations. This led to a massive loss of confidence and widespread aversion to securitized risk, including asset classes and transaction structures that were far removed from the direct source of these concerns.

5. **A breakdown in checks and balances and lack of shared responsibility for the system as a whole.** While many within the securitization industry were aware of the general deterioration in credit underwriting standards and the other factors outlined above, no single party or group of market participants enforced sufficient discipline across all parts of the interdependent securitization value chain. Weaknesses and deficiencies in one part of the chain thus impaired the function of the chain in its entirety.

It is important to note that the weaknesses outlined above are not inherent in securitization per se. Instead, they relate to the manner in which securitization was used in some settings by some market participants. In general, the amount of risk inherent in a securitization is equal to the risk that is embedded in the securitized assets themselves. However, in retrospect it is clear that securitization technology can be used in ways that can reduce and distribute risk (i.e., can be beneficial to the financial system), or that increase and concentrate that risk (i.e., can be detri-
The exact language used by the IMF in its Global Financial Stability Report states: “While most of the current proposals are unambiguously positive for securitization markets and financial stability, some proposals—such as those designed to improve the alignment of securitizer and investor interests and accounting changes that will result in more securitized assets remaining on balance sheets—may be combined in ways that could halt, not restart, securitization, by inadvertently making it too costly for securitizers.” See, “The Road to Recovery”, (Oct. 2009), p. 29. http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf.
and standardize that information and data as well as key documentation provisions, market practices and procedures employed in securitization transactions.

2. **Required Risk Retention and Other Incentive Alignment Mechanisms.** Mandated requirements for asset originators and/or securitizers to retain an economic interest in securitization transactions, and other mechanisms designed to produce a closer alignment of economic risks and incentives of originators, securitizers, and end investors.

3. **Increased Regulatory Capital Requirements and Limitations on Off-Balance Sheet Accounting.** Increases in regulatory capital required to be held against securitized exposures by regulated financial institutions, as a means of creating an additional safety and soundness buffer against potential losses associated with those exposures, and revisions to generally accepted accounting standards that restrict off-balance sheet accounting for securitized transactions and produce more widespread accounting consolidation of the assets and liabilities of securitization special purpose entities.

4. **Credit Rating Agency Reforms.** Various reforms intended to eliminate or minimize conflicts of interest, and to promote the accuracy, integrity and transparency of methodologies and processes that credit rating agencies apply to securitization transactions.

A summary of ASF’s views on each of these reform directions and initiatives are set forth below.

A. **Increased Transparency, Disclosure, Standardization; and Improvements to the Securitization Market Infrastructure**

ASF supports increased transparency and standardization in the securitization markets, and related improvements to the securitization market infrastructure. We believe that such efforts should be focused on those areas and products where pre-existing practices have been determined to be deficient, and where improvements can help restore confidence and function to the related market segment(s).

Our principal focus in this area is ASF’s Project on Residential Securitization Transparency and Reporting (Project RESTART), which is initially directed at addressing transparency and standardization deficiencies in the residential mortgage-backed securities (RMBS) market. Prior studies and market surveys conducted by ASF have clearly identified the RMBS market as most in need of these types of reform.

Overall, Project RESTART seeks to address transparency and standardization needs in the RMBS market via the substantial injection of new disclosures and reporting by issuers and servicers on new transactions as well as on the trillions of dollars of outstanding private-label RMBS. Project RESTART would create a uniform set of data standards for such disclosure and reporting, including at the loan level. This will create a more level playing field where issuers provide the same information at the initiation of a securitization transaction and on an ongoing basis throughout the life of that transaction. With these standards in place, information provided by different issuers will be more comparable and capable of meaningful evaluation by investors and other market participants. In addition to supporting investment analysis, these data and standardization improvements will also support more robust and reliable rating agency, due diligence, quality review and valuation processes, and other downstream applications that will benefit from more robust, reliable and comparable underlying data.

Project RESTART for RMBS transactions consists of the following phases: (i) the Disclosure Package, which will provide substantially more loan-level data than is currently available to investors, rating agencies and other parties, and standardize the presentation of transaction-level and loan-level data to allow for a more ready comparison of transactions and loans across issuers; (ii) the Reporting Package, which will provide for monthly updating of critical loan-level information that will enable improvements in the ability of investors, rating agencies and other market participants to analyze the performance of outstanding securities; (iii) Model RMBS Representations and Warranties, which will provide assurances to investors in RMBS transactions regarding the allocation and assumption of risk associated with loan origination and underwriting practices; (iv) Model Repurchase Procedures, which will be used to enforce the Model Representations and Warranties and to clearly delineate the roles and responsibilities of transaction parties in the repurchase process; (v) Model Pre-Securitization Due Diligence Standards, which will buttress due diligence and quality review practices relating to mortgage underwriting and origination practices and the data supplied to market participants through the Disclosure Package; and (vi) Model Servicing Provisions for Pooling and Servicing Agreements, which will create more standardized documentation provisions and
work rules in key areas, such as loss mitigation procedures that servicers may employ in dealing with delinquent or defaulting loans.

Final versions of the Disclosure and Reporting Packages were released by ASF in July 2009, with industry implementation beginning in 2010. Work continues on the other Project RESTART workstreams identified above, with an immediate focus on the development of Model RMBS Representations and Warranties, which are used to act as a “return policy” to guard against the risk of defective mortgage loans being sold into a securitization trust. Much like a defective product is returned to the store from which it was sold, a defective mortgage loan will be “returned” to the issuer through its removal from a securitization trust for cash. A mortgage loan is “defective” if it materially breaches one of the representations and warranties. Examples of defects range from a general fraud in a loan’s origination to a failure to properly verify a borrower’s income or employ an independent appraiser. The ASF supports 100 percent risk retention for defective loans that result from an originator’s failure to meet specified underwriting criteria.

Although Project RESTART has initially been focused on the RMBS market, members of the ASF have begun development of the ASF Credit Card ABS Disclosure Package, which seeks to provide increased transparency and standardization to the Credit Card ABS market.

Finally, ASF believes that every mortgage loan should be assigned a unique identification number at origination, which would facilitate the identification and tracking of individual loans as they are sold or financed in the secondary market, including via RMBS securitization. ASF recently selected a vendor who will work with us to provide this unique Loan ID, which is called the ASF LINC™. Implementation of the ASF LINC will enable market participants to access Project RESTART’s valuable loan-level information without violating privacy laws by removing personal nonpublic information and other protected information from the process.

B. Required Risk Retention

ASF supports initiatives to align the economic interests of asset originators and securitization sponsors with investors. As suggested above, we believe that the principal goal of these efforts should be to establish and reinforce commercial incentives for originators and sponsors to create and fund assets that conform to stated underwriting standards and securitization eligibility criteria, thereby making those parties economically responsible for the stated attributes and underwriting quality of securitized loans. The creation and maintenance of effective mechanisms of this type will facilitate responsible lending, as well as a more disciplined and efficient funding of consumer assets via securitization (i.e., where the varying credit and performance risks presented by different types of securitized assets can be properly evaluated and priced in the capital markets).

Securitization risk retention proposals currently under consideration, including legislation advanced by the Obama Administration, call for securitization sponsors and/or asset originators to retain an economic interest in a material portion of the credit risk that the sponsor and/or asset originator conveys to a third party via a securitization transaction.

As noted above, we support the concept of requiring retention of a meaningful economic interest in securitized loans as a means of creating a better alignment of incentives among transaction participants. Many securitizations already embed this concept through various structuring mechanisms, including via the retention of subordinated or equity risk in the securitization, holding portfolio assets bearing credit exposure that is similar or identical to that of securitized assets, and representations and warranties that require originators or sponsors to repurchase assets that fail to meet stated securitization eligibility requirements, among others. However, we do not believe that mandated retention of specific portions of credit risk—one such form of economic interest—necessarily constitutes the sole or most effective means of achieving this alignment in all cases.

There are numerous valid and competing policy goals that stand in opposition to requiring the retention of credit risk in securitized assets and exposures. Among others, these include the proper isolation of transferred assets (i.e., meeting legal criteria necessary to effect a “true sale”); reduction and management of risk on financial institutions’ balance sheets; balance sheet management; and the redeployment of capital to enable financial institutions to originate more credit than their limited capital resources would otherwise allow. Balancing these competing and worthwhile policy goals suggests that retention and incentive alignment mechanisms other than universal credit risk retention requirements should be considered. This viewpoint was echoed by the IMF last week in its Global Financial Stability Report, which expressed strong concerns about the potential unintended negative consequences of implementing suggested credit risk retention requirements and in-
stead indicated that regulatory authorities “should consider other mechanisms that incentivize due diligence and may be able to produce results comparable to a retention requirement, including, perhaps, representations and warranties.”

We believe that the risk or “skin in the game” traditionally retained by originators of RMBS is embodied in the representations and warranties that issuers provide with respect to the mortgage loans sold into the securitization trust. These representations and warranties are designed to ensure that the loans are free from undisclosed origination risks, leaving the investor primarily with normal risks of loan ownership, such as the deterioration of the borrower’s credit due to loss of employment, disability or other “life events.” However, many market participants have indicated that the traditional representations and warranties and their related remedy provisions have not sufficiently provided a means to return defective loans to the originator. Because of this, the ASF has sought to enhance and standardize these items through the previously discussed Project RESTART Model RMBS Representations and Warranties and Model Repurchase Provisions.

We therefore believe that to the extent legislation is adopted to require risk retention, regulators should have flexibility to develop and apply alternative retention mechanisms. This flexibility should include the ability for regulators to specify permissible forms and amounts of retention, how retention requirements may be calculated and measured, the duration of retention requirements, whether and to what extent hedging or risk management of retained positions is permissible, and other implementation details.

Finally, we believe that it is imperative to achieve global harmonization and consistency of policy approaches to securitization risk retention. Different approaches are being considered and/or have been adopted in different jurisdictions. Given the global nature of securitization activity and the mobility of global capital among jurisdictions, significant competitive disparities and inefficiencies may be produced by introducing substantively different retention standards throughout the world’s financial markets. We believe that is essential for policymakers to coordinate their approaches in this area.

C. Increased Regulatory Capital and Limitations on Off-Balance Sheet Financing

The Obama Administration has advocated that risk-based regulatory capital requirements should appropriately reflect the risk of structured credit products, including the concentrated risk of senior tranches and resecuritizations and the risk of exposures held in highly leveraged off-balance sheet vehicles. Global policymakers have also advocated for minimizing opportunities for financial institutions to use securitization to reduce their regulatory capital requirements without a commensurate reduction in risk.

Consistent with the above views, the Basel Committee on Banking Supervision has amended the Basel II risk-based capital framework to require additional regulatory capital to be held against certain resecuritizations (such as CDOs), on the basis that previous rules underestimated the risks inherent in such structures. In the U.S., the combined bank regulatory agencies recently issued proposals that would continue to link risk-based capital requirements to whether an accounting sale has occurred under U.S. GAAP. Given that recent accounting changes (which will generally take effect in January 2010) will make it very difficult to achieve GAAP sales in many securitizations, including both term asset-backed securities and asset-backed commercial paper vehicles, these proposed rules will likely materially increase the capital that financial institutions will be required to hold in against securitizations, since many securitized assets will remain on or return to those institutions’ balance sheets.

ASF supports efforts to address weaknesses in the risk-based capital framework that have been revealed in certain securitization products by the recent financial market dislocation, and agrees that regulatory capital levels should adequately reflect the risks of different types of securitization transactions. Furthermore, ASF...
supports efforts to reduce or eliminate opportunities for regulatory capital arbitrage that are unrelated to differences in the risk profiles of securitization instruments.

We therefore believe that increases in regulatory capital requirements for certain securitizations may be appropriate, based on the conclusion that they present more risk than had been previously understood (for example, because of their use of leverage or where underlying risk positions are more highly correlated than they were assumed to be, as in the case of certain CDOs and SIVs). However, a broader increase in capital requirements for securitization across the board, that is not tied to the differing risk profiles of different transactions, may produce very negative consequences for the economic viability of securitization. In turn, this outcome could unduly constrain the ability of financial institutions to originate and fund consumer and business credit demand, particularly as the broader economy begins to recover.

ASF is particularly concerned that linking risk-based capital requirements to accounting outcomes—particularly when those outcomes are produced by the application of accounting standards that are not themselves risk-based—is an inappropriate policy response. We believe that the resulting increase in regulatory capital required to be held against securitized assets held on financial institutions' balance sheets will grossly misrepresent the actual, incremental risk inherent in those assets. We believe that a more targeted approach to revising the securitization risk-based capital framework is warranted. Last week ASF asked the U.S. bank regulatory agencies for a 6-month moratorium relating to any changes in bank regulatory capital requirements resulting from the implementation of FASB's Statements 166 and 167. We believe that this action is necessary to avoid a potentially severe capital and credit shock to the financial system as of January 1st, when the new accounting rules generally take effect. We will be providing detailed input and recommendations to bank regulatory agencies and other policymakers on this important topic by the October 15th deadline.

D. Rating Agency Reforms

ASF supports credit rating reform in the securitization markets, focusing on steps designed to increase the quality, accuracy and integrity of credit ratings and the transparency of the ratings process. Credit ratings have occupied a central role in the securitization markets, providing investors and other market participants with expert views on the credit performance and risks associated with a wide range of securitization products. As an outgrowth of the financial market crisis, confidence in rating agencies and the ratings process for securitization have been significantly impaired. We believe that a restoration of such confidence is a necessary step in restoring broader confidence and function to the securitization markets.

Various credit rating reform measures targeting the securitization markets have been advanced by policymakers, and a number of proposals have been adopted or remain under consideration by the Securities Exchange Commission. Our views on some of the more significant proposals affecting the securitization market are summarized below:30

1. Conflicts of Interest. We support measures aimed at developing and enhancing strong conflict of interest policies and rules governing the operations of credit rating agencies. We believe that effective management and disclosure of actual and potential conflicts is a necessary component for ensuring transparency and integrity in the rating process.

2. Differentiation of Structured Finance Ratings. ASF supports full and transparent disclosure of the basis for structured finance ratings, so that the risk of securitizations can be understood and differentiated from risks presented by other types of credit instruments. However, we strongly oppose proposals advocating that a special ratings designation or modifier be required for structured finance ratings. We believe that such a designation or modifier would not convey any meaningful information about the rating, and would require significant revisions to private investment guidelines that incorporate ratings requirements.

3. Ratings Performance Disclosure. We support the publication in a format reasonably accessible to investors of a record of all ratings actions for

30For more detail on ASF's views on these and other credit rating agency reform proposals, see the series of letters submitted to the SEC by ASF between May and September of 2008. These letters may be found at: http://www.americansecuritization.com/uploadedFiles/ASFpercent20CRApercent20percent20ratingspercent20scale.pdf (May 2008); http://www.americansecuritization.com/uploadedFiles/Release_3457967_ASFComment_Letter.pdf (July 2008); and http://www.americansecuritization.com/uploadedFiles/ASF_Final_SEC_CRA—Letter_9_5_08.pdf (Sept. 2008).
securitization instruments for which ratings are published. We believe that publication of these data will enable investors and other market participants to evaluate and compare the performance, stability, and quality of ratings judgments over time.

4. Disclosure of Ratings Methods and Processes. ASF strongly supports enhanced disclosure of securitization ratings methods and processes, including information relating to the use of ratings models and key assumptions utilized by those models.

5. Reliance on Ratings. We believe that investors and other market participants, including regulators, should not place an undue reliance on credit ratings, and should employ other mechanisms for performing an independent credit analysis. However, ASF believes that credit ratings are an important part of existing regulatory regimes, and that steps aimed at reducing or eliminating the use of ratings in regulation should be considered carefully, to avoid undue disruption to market function and efficiency.

Conclusion

The securitization market is an essential mechanism for supporting credit creation and capital formation throughout the consumer and business economy. Its role is even more important today, when other sources of credit and financing are limited, due to balance sheet, capital, and liquidity constraints facing financial institutions. Securitization activity was significantly impaired as a consequence of the financial market crisis. While portions of the securitization market have recovered to some extent throughout 2009, other market segments remain significantly challenged.

The financial market crisis revealed weaknesses in several key areas of securitization market activity. Targeted reforms are needed, and a number are being pursued through both public- and private-sector responses. In pursuing market reforms and redressing these weaknesses, care should be taken to avoid imposing undue impediments to the restoration of securitization activity that could adversely impact credit availability and retard economic recovery and growth.

Thank you for the opportunity to share these views, and I look forward to answering any questions that Members of the Subcommittee may have.

PREPARED STATEMENT OF ANDREW DAVIDSON
PRESIDENT, ANDREW DAVIDSON AND COMPANY
OCTOBER 7, 2009

Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to testify before you today about securitization. My expertise is primarily in the securitization of residential mortgages and my comments will be primarily directed toward those markets.

Securitization has been a force for both good and bad in our economy. A well functioning securitization market expands the availability of credit for economic activity and home ownership. It allows banks and other financial institutions to access capital and reduces risk. On the other hand a poorly functioning securitization market may lead to misallocation of capital and exacerbate risk.1

Before delving into a discussion of the current crisis, I would like to distinguish three types of capital markets activities that are often discussed together: Securitization, Structuring, and Derivatives.2 Securitization is the process of converting individual loans into securities that can be freely transferred. Securitization serves to separate origination and investment functions.

Without securitization investors would need to go through a very complex process of transferring the ownership of individual loans. The agency mortgage-backed securities (MBS) from Ginnie Mae, Fannie Mae, and Freddie Mac are one of the most successful financial innovations. However, as the last years have taught us, the so-called, “originate to sell” model, especially as reflected in private-label (nonagency) MBS, has serious shortcomings.

Structuring is the process of segmenting the cash flows of one set of financial instruments into several bonds which are often called tranches. The collateralized

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1 Portions of this statement are derived from “Securitization: After the Fall”, Anthony Sanders and Andrew Davidson, forthcoming.
mortgage obligation or CMO is a classic example of structuring. The CMO transforms mortgage cash flows into a variety of bonds that appeal to investors from short-term stable bonds, to long-term investments. Private label MBS use a second form of structuring to allocate credit risk. A typical structure uses subordination, or over-collateralization, to create bonds with different degrees of credit risk. The collateralized debt obligation or CDO is a third form of structuring. In this case, bonds, rather than loans, are the underlying collateral for the CDO bonds which are segmented by credit risk. Structuring allows for the expansion of the investor base for mortgage cash flows, by tailoring the bonds characteristics to investor requirements. Unfortunately, structuring has also been used to design bonds that obfuscate risk and return.

Derivatives, or indexed contracts, are used to transfer risk from one party to another. Derivatives are a zero sum game in that one investor's gain is another's loss. While typically people think of swaps markets and futures markets when they mention derivatives, the TBA (to be announced) market for agency pass-through mortgages is a large successful derivative market. The TBA market allows for trading in pass-through MBS without the need to specify which pool of mortgages will be delivered. More recently a large market in mortgage credit risk has developed. The instruments in this market are credit default swaps (CDS) and ABX, an over-the-counter index based on subprime mortgage CDS. Derivatives allow for risk transfer and can be powerful vehicles for risk management. On the other hand, derivatives may lead to the creation of more risk in the economy as derivative volume may exceed the underlying asset by substantial orders of magnitude.

For any of these products to be economically useful they should address one or more of the underlying investment risks of mortgages: funding, interest rate risk, prepayment risk, credit risk, and liquidity. More than anything else mortgages represent the funding of home purchases. The twelve trillion of mortgages represents funding for the residential real estate of the country. Interest rate risk arises due to the fixed coupon on mortgages. For adjustable rate mortgages it arises from the caps, floors and other coupon limitations present in residential mortgage products. Interest rate risk is compounded by prepayment risk. Prepayment risk reflects both a systematic component that arises from the option to refinance (creating the option features of MBS) as well as the additional uncertainty created by the difficulty in accurately forecasting the behavior of borrowers. Credit risk represents the possibility that borrowers will be unable or unwilling to make their contractual payments. Credit risk reflects the borrower's financial situation, the terms of the loan and the value of the home. Credit risk has systematic components related to the performance of the economy; idiosyncratic risks related to individual borrowers and operational risks related to underwriting and monitoring. Finally, liquidity represents the ability to transfer the funding obligation and/or the risks of the mortgages.

In addition to the financial characteristics of these financial tools, they all have tax, regulatory and accounting features that affect their viability. In some cases tax, regulatory and accounting outcomes rather than financial benefit are the primary purpose of a transaction. In developing policy alternatives each of these activities: securitization, structuring and derivatives, pose distinct but interrelated challenges.

Role of Securitization in the Current Financial Crisis

The current economic crisis represents a combination of many factors and blame can be laid far and wide. Additional analysis may be required to truly assess the causes of the crisis. Nevertheless I believe that securitization contributed to the crisis in two important ways. It contributed to the excessive rise in home prices and it created instability once the crisis began.

First, the process of securitization as implemented during the period leading up to the crisis allowed a decline in underwriting standards and excessive leverage in home ownership. The excess lending likely contributed to the rapid rise in home prices leading up to the crisis. In addition to the well documented growth in subprime and Alt-A lending, we find that the quality of loans declined during the period from 2003 to 2005, even after adjusting for loan to value ratios, FICO scores, documentation type, home prices and other factors reflected in data available to investors. The results of our analysis are shown in Figure 1. It shows that the rate of delinquency for loans originated in 2006 is more than 50 percent higher than loans originated in 2003. The implication is that the quality of underwriting declined significantly during this period, and this decline was not reflected in the data provided to investors. As such it could reflect fraud, misrepresentations and lower standard for verifying borrower and collateral data. The net impact of this is that borrowers were granted credit at greater leverage and at lower cost than in prior years.
In concrete terms, the securitization market during 2005 and 2006 was pricing mortgage loans to an expected lifetime loss of about 5 percent. Our view is that even if home prices had remained stable, these losses would have been 10 percent or more. Given the structure of many of these loans, with a 2-year initial coupon and an expected payoff by the borrower at reset, the rate on the loans should have been 200 or 300 basis points higher. That is, initial coupons should have been over 10 percent rather than near 8 percent.

Our analysis further indicates that this lower cost of credit inflated home prices. The combination of relaxed underwriting standards and affordability products, such as option-arms, effectively lowered the required payment on mortgages. The lower payment served to increase the price of homes that borrowers could afford. Figure 2 shows the rapid rise in the perceived price that borrowers could afford in the Los Angeles area due to these reduced payment requirements. Actual home prices then followed this pattern. Generally we find that securitization of subprime loans and other affordability products such as option arms were more prevalent in the areas with high amounts of home price appreciation during 2003 to 2006. To be clear, not all of the affordability loans were driven by securitization, as many of the option arms remained on the balance sheet of lending institutions.

Figure 2.
Figure 3 provides an indication of the magnitude of home price increases that may have resulted from these products on a national basis. Based on our home price model, we estimate that home prices may have risen by 15 percent at the national level due to lower effective interest rates. In the chart, the gap between the solid blue line and the dashed blue line reflects the impact of easy credit on home prices.

On the flip side, we believe that the shutting down of these markets and the reduced availability of mortgage credit contributed to the sharp decline in home prices we have seen since 2006 as shown in Figure 4. Without an increase in effective mortgage rates, home prices might have sustained their inflated values as shown by the dashed blue line.  

Thus the reduced focus on underwriting quality lead to an unsustainable level of excess leverage and reduced borrowing costs which helped to inflate home prices.

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When these “affordability” products were no longer sustainable in the market, they contributed to the deflation of the housing bubble.

The way securitization was implemented during this period fostered high home prices through poor underwriting, and the end of that era may have led to the sharp decline in home prices and the sharp decline in home prices helped to spread the financial crisis beyond the subprime market.

The second way that securitization contributed to the current economic crisis is through the obfuscation of risk. For many structures in the securitization market: especially collateralized debt obligations, structured investment vehicles and other resecuritizations, there is and was insufficient information for investors to formulate an independent judgment of the risks and value of the investment. As markets began to decline in late 2007, investors in all of these instruments and investors in the institutions that held or issued these instruments were unable to assess the level of risk they bore.

This lack of information quickly became a lack of confidence and led to a massive deleveraging of our financial system. This deleveraging further depressed the value of these complex securities and led to real declines in economic value as the economy entered a severe recession. In addition, regulators lacked the ability to assess the level of risk in regulated entities, perhaps delaying corrective action or other steps that could have reduced risk levels earlier.

**Limitations of Securitization Revealed**

To understand how the current market structure could lead to undisciplined lending and obfuscation of risk it is useful to look at a simplified schematic of the market.4

Figure 5.

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4Adapted from “Six Degrees of Separation”, August 2007, by Andrew Davidson [http://www.securitization.net/pdf/content/ADC_SixDegrees_1Aug07.pdf](http://www.securitization.net/pdf/content/ADC_SixDegrees_1Aug07.pdf).
• A borrower—who wants a loan for home purchase or refinance
• A broker—who works with the borrower and lenders to arrange a loan
• A mortgage banker—who funds the loan and then sells the loan
• An aggregator—(often a broker-dealer) who buys loans and then packages the
  loans into a securitization, whose bonds are sold to investors.
• A CDO manager—who buys a portfolio of mortgage-backed securities and issues
debt
• An investor—who buys the CDO debt

Two additional participants are also involved:
• A servicer—who keeps the loan documents and collects the payments from the
  borrower
• A rating agency—that places a rating on the mortgage securities and on the
  CDO debt

This chart is obviously a simplification of a more complex process. For example,
CDOs were not the only purchasers of risk in the subprime market. They were how-
ever a dominant player, with some estimating that they bought about 70 percent
of the lower rated classes of subprime mortgage securitizations. What is clear even
from this simplified process is that contact between the provider of risk capital and
the borrower was very attenuated.

A central problem with the securitization market, especially for subprime loans
was that no one was the gate keeper, shutting the door on uneconomic loans. The
ultimate CDO bond investor placed his trust in the first loss investor, the rating
agencies, and the CDO manager, and in each case that trust was misplaced.

Ideally mortgage transactions are generally structured so that someone close to
the origination process would take the first slice of credit risk and thus insure that
loans were originated properly. In the subprime market, however it was possible to
originate loans and sell them at such a high price, that even if the mortgage banker
or aggregator retained a first loss piece (or residual) the transaction could be profit-
able even if the loans did not perform well. Furthermore, the terms of the residuals
were set so that the owner of the residual might receive a substantial portion of
their cash flows before the full extent of losses were known.

Rating agencies set criteria to establish credit enhancement levels that ultimately
led to ratings on bonds. The rating agencies generally rely on historical statistical
analysis to set ratings. The rating agencies also depend on numeric descriptions of
loans like loan-to-value ratios and debt-to-income ratios to make their determina-
tions. Rating agencies usually do not review loans files or “re-underwrite” loans.
Rating agencies also do not share in the economic costs of loan defaults. The rating
agencies methodology allowed for the inclusion of loans of dubious quality into
subprime and Alt-A mortgage pools, including low documentation loans for bor-
rowers with poor payment histories, without the offsetting requirement of high
down payments.

To help assure investors of the reliability of information about the risks of pur-
chased loans, the mortgage market has developed the practice of requiring “repre-
sentations and warranties” on purchased loans. These reps and warrants as they
are called, are designed to insure that the loans sold meet the guidelines of the pur-
chasers. This is because mortgage market participants have long recognized that
there is substantial risk in acquiring loans originated by someone else. An essential
component in having valuable reps and warrants is that the provider of those prom-
ises have sufficient capital to back up their obligations to repurchase loans subse-
quently determined to be inconsistent with the reps and warrants. A financial guar-
antee from an insolvent provider has no value.

Representations and warranties are the glue that holds the process together; if
the glue is weak the system can collapse.

The rating agencies also established criteria for Collateralized Debt Obligations
that allowed CDO managers to produce very highly leveraged portfolios of subprime
mortgage securities. The basic mechanism for this was a model that predicted the
performance of subprime mortgage pools were not likely to be highly correlated.
That is defaults in one pool were not likely to occur at the same time as defaults
in another pool. This assumption was at best optimistic and most likely just wrong.

In the CDO market the rating agencies have a unique position. In most of their
other ratings business, a company or a transaction exists or is likely to occur and
the rating agency reviews that company or transaction and establishes ratings. In
the CDO market, the criteria of the rating agency determine whether or not the
transaction will occur. A CDO is like a financial institution. It buys assets and
issues debt. If the rating agency establishes criteria that allow the institution to bor-
row money at a low enough rate or at high enough leverage, then the CDO can purchase assets more competitively than other financial institutions. If the CDO has a higher cost of debt or lower leverage, then it will be at a disadvantage to other buyers and will not be brought into existence. If the CDO is created, the rating agency is compensated for its ratings. If the CDO is not created, there is no compensation. My view is that there are very few institutions that can remain objective given such a compensation scheme.

CDO bond investors also relied upon the CDO manager to guide them in the dangerous waters of mortgage investing. Here again investors were not well served by the compensation scheme. In many cases CDO managers receive fees that are independent of the performance of the deals they manage. While CDO managers sometimes keep an equity interest in the transactions they manage, the deals are often structured in such a way that the deal can return the initial equity investment even if some of the bonds have losses. Moreover, many of the CDOs were managed by start-up firms with little or no capital.

Nevertheless, much of the responsibility should rest with the investors. CDO bond investors were not blind to the additional risks posed by CDO investing. CDOs generally provided higher yields than similarly rated bonds, and it is an extremely naive, and to my mind, rare, investor who thinks they get higher returns without incremental risk. It is not unusual, however, for investors not to realize the magnitude of additional risk they bear for a modest incremental return. Ultimately it is investors who bear the losses, and investors must bear the bulk of the burden in evaluating their investments. There were clear warning signs for several years as to the problems and risk of investing in subprime mortgages. Nevertheless, investors continued to participate in this sector as the risks grew and reward decreased.

As expressed herein, the primary problem facing securitization is a failure of industrial organization. The key risk allocators in the market, the CDO managers, were too far from the origination process and, at best, they believed the originators and the rating agencies were responsible for limiting risk. At the origination end, without the discipline of a skeptical buyer, abuses grew. The buyer was not sufficiently concerned with the process of loan origination and the broker was not subject to sufficient constraints.

Current Conditions of the Mortgage-backed Securities Market

More than 2 years after the announcement of the collapse of the Bear Stearns High Grade Structured Credit Enhanced Leverage Fund the mortgage market remains in a distressed state. Little of the mortgage market is functioning without the direct involvement of the U.S. Government, and access to financing for mortgage originators and investors is still limited.

Fortunately there are the beginning signs of stabilization of home prices, but rising unemployment threatens the recovery. In the secondary market for mortgage-backed securities there has been considerable recovery in price in some sectors, but overall demand is being propped up by large purchases of MBS by the Federal Reserve Bank.

In addition, we find that many of our clients are primarily focused on accounting and regulatory concerns related to legacy positions, and less effort is focused on the economic analysis of current and future opportunities. That situation may be changing as over the past few months we have seen some firms begin to focus on longer term goals.

The Effectiveness of Government Action

I have not performed an independent analysis of the effectiveness of Government actions, so by comments are limited to my impressions.

Government involvement has been beneficial in a number of significant respects. Without Government involvement in Fannie Mae, Freddie Mac, and FHA lending programs, virtually all mortgage lending could have stalled. What lending would have existed would have been for only the absolute highest quality borrowers and at restrictive rates. In addition Government programs to provide liquidity have also been beneficial to the market as private lending was reduced to extremely low levels. Government and Federal Reserve purchases of MBS have kept mortgage rates low. This has probably helped to bolster home prices.

On the other hand the start/stop nature of the buying programs under TARP and PPIP has probably been a net negative for the market. Market participants have held back on investments in anticipation of Government programs that either did not materialize or were substantially smaller in scope than expected.

Furthermore Government efforts to influence loan modifications, while beneficial for some home owners, and possibly even investors, have created confusion and distrust. Investors are more reluctant to commit capital when the rules are uncertain.
In my opinion there has been excessive focus on loan modifications as a solution to the current crisis. Loan modifications make sense for a certain portion of borrowers whose income has been temporarily disrupted or have sufficient income to support a modestly reduced loan amount and the willingness to make those payments. However, for many borrowers, loan modifications cannot produce sustainable outcomes. In addition, loan modifications must deal with the complexities of multiple liens and complex ownership structures of mortgage loans. Short sales, short payoffs, and relocation assistance for borrowers are other alternatives that should be given greater weight in policy development.

The extensive Government involvement in the mortgage market has likely produced significant positive benefits to the economy. However unwinding the Government role will be quite complex and could be disruptive to the recovery. Government programs need to be reduced and legislative and regulatory uncertainties need to be addressed to attract private capital back into these markets.

Legislative and Regulatory Recommendations

I believe that the problems in the securitization market were essentially due to a failure of industrial organization. Solutions should address these industrial organization failures. While some may seek to limit the risks in the economy, I believe a better solution is to make sure the risks are borne by parties who have the capacity to manage the risks or the capital to bear those risks. In practical terms, this means that ultimately investors, as the creators of leverage, must be responsible for limiting leverage to economically sustainable levels that do not create excessive risk to their stakeholders. Moreover, lenders should not allow equity investors to have tremendous upside with little exposure to downside risk. Equity investors who have sufficient capital at risk are more likely to act prudently. Consequently, all the information needed to assess and manage risks must be adequately disclosed and investors should have assurances that the information they rely upon is accurate and timely. Likewise when the Government acts as a guarantor, whether explicitly or implicitly, it must ensure that it is not encouraging excessive risk taking and must have access to critical information on the risks borne by regulated entities.

In this light, I would like to comment on the Administration proposals on Securitization in the white paper: “Financial Regulatory Reform: A New Foundation.”

Recommendations 1 and 2 cover similar ground:

1. Federal banking agencies should promulgate regulations that require originators or sponsors to retain an economic interest in a material portion of the credit risk of securitized credit exposures.

   The Federal banking agencies should promulgate regulations that require loan originators or sponsors to retain 5 percent of the credit risk of securitized exposures.

2. Regulators should promulgate additional regulations to align compensation of market participants with longer term performance of the underlying loans.

   Sponsors of securitizations should be required to provide assurances to investors, in the form of strong, standardized representations and warranties, regarding the risk associated with the origination and underwriting practices for the securitized loans underlying ABS.

Clearly excessive leverage and lack of economic discipline was at the heart of the problems with securitization. As described above the market failed to adequately protect investors from weakened underwriting standards. Additional capital requirements certainly should be part of the solution. However, such requirements need to be constructed carefully. Too little capital and it will not have any effect; too much and it will inhibit lending and lead to higher mortgage costs. The current recommendation for retention of 5 percent of the credit risk does not seem to strike that balance appropriately.

When a loan is originated there are several kinds of credit related risks that are created. In addition to systematic risks related to future events such as changes in home prices and idiosyncratic risks such as changes in the income of the borrower, there are also operational risks related to the quality of the underwriting and servicing. An example of an underwriting risk is whether or not the borrower's income and current value of their home were verified appropriately. Originators are well positioned to reduce the operational risks associated with underwriting and fight fraud, but they may be less well positioned to bear the long term systematic and

idiosyncratic risks associated with mortgage lending. Investors are well positioned to bear systemic risks and diversify idiosyncratic risks, but are not able to assess the risks of poor underwriting and servicing. The securitization process should ensure that there is sufficient motivation and capital for originators to manage and bear the risks of underwriting and sufficient information made available to investors to assess the risks they take on.

The current form of representations and warranties is flawed in that it does not provide a direct obligation from the originator to the investor. Instead representations and warranties pass through a chain of ownership and are often limited by “knowledge” and capital. In addition current remedies are tied to damages and in a rising home price market calculated damages may be limited. Thus a period of rising home prices can mask declining credit quality and rising violations of representations and warranties.

Therefore, incentives and penalties should be established to limit unacceptable behavior such as fraud, misrepresentations, predatory lending. If the goal is to prevent fraud, abuse and misrepresentations rather than to limit risk transfer then there needs to be a better system to enforce the rights of borrowers and investors than simply requiring a originators to retain a set percentage of credit risk.

I have proposed a “securitization certificate” which would travel with the loan and would be accompanied by appropriate assurances of financial responsibility. The certificate would replace representations and warranties, which travel through the chain of buyers and sellers and are often unenforced or weakened by the successive loan transfers. The certificate could also serve to protect borrowers from fraudulent origination practices in the place of assignee liability. Furthermore the certificate should be structured so that there are penalties for violations regardless of whether or not the investor or the borrower has experienced financial loss. The record of violations of these origination responsibilities should publically available.

I have constructed a simple model of monitoring fraudulent loans. Some preliminary results are shown in Table 1. These simulations show the impact of increasing the required capital for a seller and of instituting a fine for fraudulent loans beyond the losses incurred. These results show that under the model assumptions, without a fine for fraud, sellers benefit from originating fraudulent loans. The best results are obtained when the seller faces fines for fraud and has sufficient capital to pay those fines. The table below shows the profitability of the seller and buyer for various levels of fraudulent loans. In the example below, the profits of the seller increase from .75 with no fraudulent loans to .77 with 10 percent fraudulent loans, even when the originator retains 5 percent capital against 5 percent of the credit risk. On the other hand, the sellers profit falls from .75 to .44 with 10 percent fraudulent loans even though the retained capital is only 1 percent, but there is a penalty for fraudulent loans. Thus the use of appropriate incentives can reduce capital costs, while increasing loan quality.

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Under this analysis the Treasury proposals would not have a direct effect on fraud. In fact, there is substantial risk the recommended approach of requiring minimum capital requirements for originators to bear credit risk would lead to either higher mortgage rates or increased risk taking. A better solution is to create new mechanisms to monitor and enforce the representations and warranties of originators. With adequate disclosure of risks and a workable mechanism for enforcing quality controls the securitization market can more effectively price and manage risk.

Recommendation 3 addresses the information available to investors:

3. The SEC should continue its efforts to increase the transparency and standardization of securitization markets and be given clear authority to require robust reporting by issuers of asset backed securities (ABS).

Increased transparency and standardization of securitization markets would likely to better functioning markets. In this area, Treasury charges the SEC and "industry" with these goals. I believe there needs to be consideration of a variety of institutional structures to achieve these goals. Standardization of the market can come from many sources. Possible candidates include the SEC, the American Securitization Forum, the Rating Agencies and the GSEs, Fannie Mae and Freddie Mac.

I believe the best institutions to standardize a market are those which have an economic interest in standardization and disclosure. Of all of these entities the GSEs have the best record of standardizing the market; this was especially true before their retained portfolios grew to dominate their income. (As I will discuss below, reform of the GSEs is essential for restoring securitization.) I believe a revived Fannie Mae and Freddie Mac, limited primarily to securitization, structured as member-owned cooperatives, could be an important force for standardization and disclosure.

Table 1.

<table>
<thead>
<tr>
<th>% fraudulent loans</th>
<th>0%</th>
<th>5%</th>
<th>10%</th>
<th>20%</th>
<th>33%</th>
</tr>
</thead>
<tbody>
<tr>
<td>No fraud fine 1% capital</td>
<td>Seller</td>
<td>0.75</td>
<td>0.76</td>
<td>0.82</td>
<td>1.04</td>
</tr>
<tr>
<td>Buyer</td>
<td>0.25</td>
<td>0.19</td>
<td>0.08</td>
<td>-0.19</td>
<td>-0.56</td>
</tr>
<tr>
<td>No fine with 5% capital</td>
<td>Seller</td>
<td>0.75</td>
<td>0.76</td>
<td>0.77</td>
<td>0.79</td>
</tr>
<tr>
<td>Buyer</td>
<td>0.25</td>
<td>0.19</td>
<td>0.13</td>
<td>0.01</td>
<td>-0.16</td>
</tr>
<tr>
<td>Fraud fine with 1% capital</td>
<td>Seller</td>
<td>0.75</td>
<td>0.71</td>
<td>0.44</td>
<td>0.25</td>
</tr>
<tr>
<td>Buyer</td>
<td>0.20</td>
<td>0.19</td>
<td>0.20</td>
<td>0.25</td>
<td>-0.25</td>
</tr>
<tr>
<td>Fraud fine with 5% capital</td>
<td>Seller</td>
<td>0.75</td>
<td>0.71</td>
<td>0.34</td>
<td>-0.19</td>
</tr>
<tr>
<td>Buyer</td>
<td>0.20</td>
<td>0.19</td>
<td>0.30</td>
<td>0.60</td>
<td>0.85</td>
</tr>
</tbody>
</table>
While the other candidates could achieve this goal they each face significant obstacles.

The SEC operates primarily through regulation and therefore may not be able to adapt to changing markets. While the ASF has made substantial strides in this direction, the ASF lacks enforcement power for its recommendations and has conflicting constituencies. The rating agencies have not shown the will or the power to force standardization, and such a role may be incompatible with their stated independence.

Recommendations 4 and 5 address the role of rating agencies in securitization.

4. The SEC should continue its efforts to strengthen the regulation of credit rating agencies, including measures to require that firms have robust policies and procedures that manage and disclose conflicts of interest, differentiate between structured and other products, and otherwise promote the integrity of the ratings process.

5. Regulators should reduce their use of credit ratings in regulations and supervisory practices, wherever possible.

In general I believe that the conflicts of interest facing rating agencies and their rating criteria were well known and easily discovered prior to the financial crisis. Thus I do not believe that greater regulatory authority over rating agencies will offer substantial benefits. In fact, increasing competition in ratings or altering the compensation structure of rating agencies may not serve to increase the accuracy of ratings, since most users of ratings issuers as well as investors are generally motivated to seek higher ratings. (Only if the regulatory reliance on rating agencies is reduced will these structural changes be effective.) To the extent there is reliance on rating agencies in the determination of the capital requirement for financial institutions, a safety and soundness regulators for financial institutions, such the FFIEC or its successor, should have regulatory authority over the rating agencies.

Rather than focus on better regulation, I support the second aspect of Treasury's recommendations on rating agencies (recommendation 5) and believe it would be better for safety and soundness regulators to reduce their reliance on ratings and allow the rating agencies to continue their role of providing credit opinions that can be used to supplement credit analysis performed by investors. To reduce reliance on ratings, regulators, and others will need alternative measures of credit and other risks. I believe that the appropriate alternative to ratings is analytical measures of risk. Analytical measures can be adopted, refined, and reviewed by regulators. In addition regulators should insist that regulated entities have sufficient internal capacity to assess the credit and other risks of their investments. In this way regulators would have greater focus on model assumptions and model validation and reduced dependence on the judgment of rating agencies. The use of quantitative risk measures also requires that investors and regulators have access to sufficient information about investments to perform the necessary computations. Opaque investments that depend entirely upon rating agency opinions would be clearly identified. Quantitative measures can also be used to address the concerns raised in the report about concentrations of risk and differentiate structured products and direct corporate obligations.

I recently filed a letter with the National Association of Insurance Commissioners on the American Council of Life Insurers' proposal to use an expected loss measure as an alternative to ratings for nonagency MBS in determining risk based capital. Here I would like to present some of the key points in that letter:

An analytical measure may be defined as a number, or a value, that is computed based on characteristics of a specific bond, its collateral and a variety of economic factors both historical and prospective. One such analytical measure is the probability of default and another measure is the expected loss of that bond. While an analytical measure is a numeric value that is the result of computations, it should be noted that there may still be some judgmental factors that go into its production. In contrast, a rating is a letter grade, or other scale, assigned to a bond by a rating agency. While ratings have various attributes, generally having both objective and subjective inputs, there is not a particular mathematical definition of a rating.

Analytical measures may be useful for use by regulators because they have several characteristics not present in ratings.

1. An analytical measure can be designed for a specific purpose. Specific analytical measures can be designed with particular policy or risk management goals in mind. Ratings may reflect a variety of considerations. For example, there
is some uncertainty as to whether ratings represent the first dollar of loss or the expected loss, or how expected loss is reflected in ratings.

2. Analytical measures can be updated at any frequency. Ratings are updated only when the rating agencies believe there has been sufficient change to justify an upgrade, downgrade or watch. Analytical measures can be computed any time new information is available and will show the drift in credit quality even if a bond remains within the same rating range.

3. Analytical measures can take into account price or other investor specific information. Ratings are computed for a bond and generally reflect the risk of non-payment of contractual cash flows. However, the risk to a particular investor of owning a bond will at least partially depend on the price that the bond is carried in the portfolio or the composition of the portfolio.

4. Regulators may contract directly with vendors to produce analytical results and may choose the timing of the calculations. On the other hand, ratings are generally purchased by the issuer at the time of issuance. Not only may this introduce conflicts of interest, but it also creates a greater focus on initial ratings than on surveillance and updating of ratings. In addition, once a regulator allows the use of a particular rating agency it has no further involvement in the ratings process.

5. Analytical measures based on fundamental data may also be advantageous over purely market-based measures. As market conditions evolve values of bonds may change. These changes reflect economic fundamentals, but may also reflect supply/demand dynamics, liquidity and risk preferences. Measures fully dependent on market prices may create excessive volatility in regulatory measures, especially for companies with the ability to hold bonds to maturity.

Even if regulators use analytical measures of risk, ratings from rating agencies as independent opinions would still be valuable to investors and regulators due to the multifaceted nature of ratings and rating agency analysis can be used to validate the approaches and assumptions used to compute particular analytical measures.

Additional measures beyond the credit risk of individual securities such as stress tests, market value sensitivity and measures of illiquidity may also be appropriate in the regulatory structure. The use of analytical measures rather than ratings does not eliminate the potential for mistakes. In general, any rigid system can be gamed as financial innovation can often stay ahead of regulation. To reduce this problem regulation should be based on principles and evolve with the market. Regulators should always seek to build an a margin of safety as there is always a risk that the theory underlying the regulatory regime falls short and that some participants will find mechanisms to take advantage of the regulatory structure.

Finally, as discussed by the Administration in the white paper, the future of securitization for mortgages requires the resolution of the status of Fannie/Freddie and role of FHA/GNMA. As stated above, I believe that continuation of Fannie Mae and Freddie Mac as member owned cooperatives would serve to establish standards, and provide a vehicle for the delivery of Government guarantees if so desired. The TBA, or to be announced, market has been an important component in the success of the fixed rate mortgage market in the United States. Careful consideration should be given to the desirability of fixed rate mortgages and the mechanisms for maintaining that market in discussions of the future of the GSEs.

PREPARED STATEMENT OF J. CHRISTOPHER HOEFFEL
EXECUTIVE COMMITTEE MEMBER, COMMERCIAL MORTGAGE SECURITIES ASSOCIATION
OCTOBER 7, 2009

The Commercial Mortgage Securities Association (CMSA) is grateful to Chairman Reed, Ranking Member Bunning, and the Members of the Subcommittee for giving CMSA the opportunity to share its perspective concerning the securitized credit markets for commercial real estate. In responding to the specific questions the Subcommittee has asked witnesses to address, we will focus on securitization in the commercial real estate (CRE) mortgage context and address the following issues: (1) the challenges facing the $3.5 trillion market for commercial real estate finance; (2) the unique structure of the commercial market and the need to customize regulatory reforms, and not undermine, our Nation’s economic recovery; and, (3) efforts to restore the availability of credit by promoting and enhancing the viability of commercial mortgage-backed securities (CMBS).
CMSA and the Current State of the Market

CMSA represents the full range of CMBS market participants, including investment and commercial banks; rating agencies; accounting firms, servicers; other service providers; and investors such as insurance companies, pension funds, and money managers. CMSA is a leader in the development of standardized practices and in ensuring transparency in the commercial real estate capital market finance industry.

Because our membership consists of all constituencies across the entire market, CMSA has been able to develop comprehensive responses to policy questions to promote increased market efficiency and investor confidence. For example, our members continue to work closely with policymakers in Congress, the Administration, and financial regulators, providing practical advice on measures designed to restore liquidity and facilitate lending in the commercial mortgage market (such as the Term Asset-Backed Securities Loan Facility (TALF) and the Public–Private Investment Program (PPIP)). CMSA also actively participates in the public policy debates that impact the commercial real estate capital markets.

The CMBS market is a responsible and key contributor to the overall economy that historically has provided a tremendous source of capital and liquidity to meet the needs of commercial real estate borrowers. CMBS helps support the commercial real estate markets that fuel our country’s economic growth. The loans that are financed through these markets help provide jobs and services to local communities, as well as housing for millions of Americans in multifamily dwellings.

Unfortunately, the recent turmoil in the financial markets coupled with the overall downturn in the U.S. economy have brought the CMBS market to a standstill and created many pressing challenges, specifically:

- **No liquidity or lending**—While the CMBS market provided approximately $240 billion in commercial real estate financing in 2007 (nearly 50 percent of all commercial lending), CMBS issuance fell to $12 billion in 2008, despite strong credit performance and high borrower demand. There has been no new private label CMBS issuance year-to-date in 2009, as the lending markets remain frozen;
- **Significant loan maturities through 2010**—At the same time, there are significant commercial real estate loan maturities this year and next—amounting to hundreds of billions of dollars—but the capital necessary to refinance these loans remains largely unavailable and loan extensions are difficult to achieve; and
- **The U.S. economic downturn persists**—The U.S. recession continues to negatively affect both consumer and business confidence, which impacts commercial and multifamily occupancy rates and rental income, as well as business performance and property values.

Significantly, it is important to note that the difficulties faced by the overall CRE market are not attributable solely to the current trouble in the CMBS market, but also stem from problems with unsecured CRE debt, such as construction loans. As described by Richard Parkus, an independent research analyst with Deutsche Bank who has testified before both the Joint Economic Committee and the TARP Oversight Panel, while the overall CRE market will experience serious strain (driven by poor consumer confidence and business performance, high unemployment and property depreciation), it is the nonsecuritized debt on the books of small and regional banks that will be most problematic, as the projected default rates for such unsecuritized commercial debt have been, and are expected to continue to be, significantly higher than CMBS loan default rates.

As recently as early this year, default rates in the CMBS market, which have historically been low (less than .50 percent for several years) still hovered around a mere 1.25 percent. Unfortunately, the economic recession that began as a crisis of liquidity in some sectors transformed into a crisis in confidence that affected all sectors, and it was only a matter of time before CMBS was affected. No matter the strength of our fundamentals and loan performance, once investors lost confidence and began to shy away from mortgaged-backed securities, CMBS could not avoid the contagion.

This unfortunate combination of circumstances leaves the broader CRE sector and the CMBS market with several overarching problems: (1) a liquidity gap, *i.e.*, the difference between borrowers’ demand for credit and the nearly nonexistent supply of credit; (2) an equity gap (the difference between the current market value of commercial properties and what is owed on them, which will be extremely difficult to refinance as current loans mature); and (3) the fact that potential CMBS sponsors are very reluctant to take the risk of trying to aggregate loans for securitization,
since there is no assurance that private sector investors will buy the securities, all of which serves to simply perpetuate the cycle of frozen credit markets.

**Unique Characteristics of the CMBS Market**

There are a number of important distinctions between CMBS and other asset-backed securities (ABS) markets, and those distinctions should be considered in fashioning any broad securitization-related regulatory reforms. These differences relate not only to the structure of securities, but also to the underlying collateral, the type and sophistication of the borrowers, as well as to the level of transparency in CMBS deals.

**Commercial Borrowers**

Commercial borrowers are highly sophisticated businesses with cash flows based on business operations and/or tenants under leases. This characteristic stands in stark contrast to the residential market where, for example, loans were underwritten in the subprime category for borrowers who may not have been able to document their income, or who may not have understood the effects of factors like floating interest rates and balloon payments on their mortgage's affordability.

Additionally, securitized commercial mortgages have different terms (generally 5–10 year “balloon” loans), and they are, in the vast majority of cases, nonrecourse loans. This means that if the borrower defaults, the lender can seize the collateral, although it may not pursue a claim against the borrower for any deficiency in recovery. This dramatically decreases the cost of default because the loan work-out recoveries in the CMBS context tend to be significantly more efficient than, for example, the residential loan foreclosure process.

**Structure of CMBS**

There are multiple levels of review and diligence concerning the collateral underlying CMBS, which help ensure that investors have a well informed, thorough understanding of the risks involved. Specifically, in-depth property-level disclosure and review are done by credit rating agencies as part of the process of rating CMBS bonds.

Moreover, nonstatistical analysis is performed on CMBS pools. This review is possible given that there are only 100–300 commercial loans in a pool that support a bond, as opposed, for example, to tens of thousands of loans in residential mortgage-backed securities pools. This limited number of loans allows market participants (investors, rating agencies, etc.) to gather detailed information about income producing properties and the integrity of their cash flows, the credit quality of tenants, and the experience and integrity of the borrower and its sponsors, and thus conduct independent and extensive due diligence on the underlying collateral supporting their CMBS investments.

**First-Loss Investor (“B-Piece Buyer”) Re-Underwrites Risk**

CMBS bond issuances include a first-loss, noninvestment grade bond component. The third-party investors that purchase these lowest-rated securities (referred to as “B-piece” or “first-loss” investors) conduct their own extensive due diligence (usually including, for example, site visits to every property that collateralizes a loan in the loan pool) and essentially re-underwrite all of the loans in the proposed pool. Because of this, the B-piece buyers often negotiate the removal of any loans they consider to be unsatisfactory from a credit perspective, and specifically negotiate with bond sponsors or originators to purchase this noninvestment-grade risk component of the bond offering. This third-party investor due diligence and negotiation occurs on every deal before the investment-grade bonds are issued.

**Greater Transparency**

A wealth of transparency currently is provided to CMBS market participants via the CMSA Investor Reporting Package® (CMSA IRP®). The CMSA IRP provides access to loan, property and bond-level information at issuance and while securities are outstanding, including updated bond balances, amount of interest and principal received, and bond ratings, as well as loan-level and property-level information on an ongoing basis. The “CMSA IRP” has been so successful in the commercial space that it is now serving as a model for the residential mortgage-backed securities market.

**Current Efforts To Restore Liquidity**

Private investors are absolutely critical to restoring credit availability in the capital finance markets. Accordingly, Government initiatives and reforms must work to encourage private investors—who bring their own capital to the table—to come back to the capital markets.
Treasury Secretary Geithner emphasized this need when he stressed during the introduction of the Administration’s Financial Stability Plan that “[b]ecause this vital source of lending has frozen up, no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses—large and small.” The importance of restoring the securitization markets is recognized globally as well, with the International Monetary Fund noting in its most recent Global Financial Stability Report that “restarting private-label securitization markets, especially in the United States, is critical to limiting the fallout from the credit crisis and to the withdrawal of central bank and Government interventions.”

As a centerpiece of the Financial Stability Plan, policymakers hope to restart the CMBS and other securitization markets through innovative initiatives (such TALF and the PPIP), and CMSA welcomes efforts to utilize private investors to help fuel private lending. In this regard, the TALF program for new CMBS issuance has been particularly helpful in our space, as evidenced in triple-A CMBS cash spreads tightening almost immediately after the program was announced, as one example.

To this end, CMSA continues to engage in an ongoing dialogue with many members of the relevant Congressional committees, as well as with key policymakers at the Treasury Department, Federal Reserve and other agencies, and participants in various sectors of the commercial real estate market. The focus of our efforts has been on creative solutions to help bring liquidity back to the commercial real estate finance markets. We appreciate policymakers’ recognition, as evidenced by programs like TALF and PPIP, that a major part of the solution will be to bring private investors back to the market through securitization. We also appreciate the willingness of Congress and other policymakers to listen to our recommendations on how to make these programs as effective as possible.

However, there is still a long way to go toward recovery in the CRE market, despite the early success of the TALF program. The market faces the overarching problems of the liquidity and equity gaps. This is driven in part by the absence of any aggregation mechanism—securitizers are unwilling to bear all of the noncredit risks (like interest rate changes) they must currently take on between the time a loan is made and when it can be securitized (a process that takes months across a pool of loans). This is especially true now when there is uncertainty as to whether there will be willing investors at the end of the process.

CMSA also is committed to working on additional long-term solutions to ensure the market is able to meet ongoing commercial borrowing demands. For example, CMSA supports efforts to facilitate a U.S. commercial covered bond market in order to provide an additional source of liquidity through new and diverse funding sources. We will continue to work with Congress on the introduction of comprehensive legislation that would include high quality commercial mortgage loans and CMBS as eligible collateral in the emerging covered bond marketplace.

Financial Regulatory Reform and Commercial Real Estate

The Administration has proposed new and unprecedented financial regulatory reform proposals that will change the nature of the securitized credit markets which are at the heart of recovery efforts. The securitization reform proposals appear to be prompted by some of the practices that were typical in the subprime and residential securitization markets. At the outset, we must note that CMSA does not oppose efforts to address such issues, as we have long been an advocate within the industry for enhanced transparency and sound practices.

As a general matter, however, policymakers must ensure that any regulatory reforms are tailored to address the specific needs of each securitization asset class. As discussed above, the structure of the CMBS market has incorporated safeguards that minimize the risky securitization practices that policymakers hope to address. Thus, the securitization reform initiatives should be tailored to take these differences into account. In doing so, policymakers can protect the viability of the markets that already are functioning in a way that does not pose a threat to overall economic stability, and ensure that such markets can continue to be a vital component of the economic recovery solution.

CMSA and its members are concerned that certain aspects of the Administration’s securitization reform proposals could undermine rather than support the Administration’s many innovative efforts to restart the securitization markets, effectively stalling recovery efforts by making lenders less willing or able to extend loans and

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involves investors less willing or able to buy CMBS bonds—two critical components to the flow of credit in the commercial market.

The two aspects of the securitization reform proposal that are of utmost concern to CMSA are a plan to require bond issuers or underwriters (referred to as “securitizers” in the Administration’s draft securitization reform bill) to retain at least 5 percent of the credit risk in any securitized asset they sell, and an associated restriction on the ability of issuers to hedge the 5 percent retained risk. Again, CMSA does not oppose these measures per se, but emphasizes that they should be tailored to reflect key differences between the different asset-backed securities markets.

Significantly, we are not alone in advocating a tailored approach. The IMF, which recently expressed concern that U.S. and European retained risk proposals may be too simplistic, warned that “[p]roposals for retention requirements should not be imposed uniformly across the board, but tailored to the type of securitization and underlying assets to ensure that those forms of securitization that already benefit from skin in the game and operate well are not weakened. The effects induced by interaction with other regulations will require careful consideration.”

**Five Percent Risk Retention for Securitizers**

The retention of risk is an important component regardless of who ultimately retains it: the originator, the issuer, or the first-loss buyer. As explained above, the CMBS structure has always had a third-party in the first-loss position that specifically negotiates to purchase this risk. Most significantly, these third-party investors are able to, and do, protect their own interests in the long-term performance of the bonds rather than relying merely on the underwriting and representations of securitizers or originators. First-loss buyers conduct their own extensive credit analysis on the loans, examining detailed information concerning every property—before buying the highest risk bonds in a CMBS securitization. In many cases, the holder of the first-loss bonds is also related to the special servicer who is responsible on behalf of all bondholders as a collective group for managing and resolving defaulted loans through workouts or foreclosure.

Thus, the policy rationale for imposing a risk retention requirement on issuers or underwriters as “securitizers” that could preclude them from transferring the first-loss position to third parties is unnecessary in this context, because, although the risk is transferred, it is transferred to a party that is acting as a “securitizer” and that is fully cognizant, through its own diligence, of the scope and magnitude of the risk it is taking on. In effect, when it comes to risk, the first-loss buyer is aware of everything the issuer or underwriter is aware of.

Because the CMBS market is structured differently than other securitization markets, policymakers’ focus in this market should be on the proper transfer of risk (e.g., sufficient collateral disclosure, adequate due diligence and/or risk assessment procedures on the part of the risk purchaser), analogous to what takes place in CMBS transactions. Therefore, CMBS securitizers should be permitted to transfer risk to B-piece buyers who—in the CMBS context at least—act as “securitizers.” To require otherwise would hamper the ability of CMBS lenders to originate new bond issuances, by needlessly tying up their capital and resources in the retained risk, which in turn, would squelch the flow of credit at a time when our economy desperately needs it.

CMSA therefore suggests that securitization legislation include a broader definition of “securitizer” than is presently in the Administration’s draft bill, to include third parties akin to the CMBS first-loss investors. Such an approach will provide explicit recognition of the ability to transfer retained risk to third parties under circumstances in which the third party agrees to retain the risk and is capable of adequately protecting its own interests.

**Prohibition on Hedging of Retained Risk**

In conjunction with the retained risk requirement, there also is a proposal to prohibit “securitizers” from hedging that risk. Rather than adopting an outright ban on hedging the retained risk, however, the measure needs to be designed to strike a balance between fulfilling the legislation’s objective of ensuring that securitizers maintain an appropriate stake in the risks they underwrite. Such tailoring is necessary to avoid imposing undue constraints on “protective” mechanisms that are legitimately used by securitizers to maintain their financial stability.

Several risks inherent in any mortgage or security exposure arise not from imprudent loan origination and underwriting practices, but from outside factors such as changes in interest rates, a sharp downturn in economic activity, or regional/geographic events such as a terrorist attack or weather-related disaster. Securitizers attempt to hedge against these market-oriented factors in keeping with current safe-
ty and soundness practices, and some examples in this category of hedges are interest rate hedges using Treasury securities, relative spread hedges (using generic interest-rate swaps), and macroeconomic hedges (that, for example, are correlated with changes in GDP or other macroeconomic factors). The hallmark of this category is that these hedges seek protection from factors the securitizer does not control, and the hedging has neither the purpose nor the effect of shielding the originators or sponsors from credit exposures on individual loans.

As such, hedges relate to generally uncontrollable market forces that cannot be controlled independently. There is no way to ensure that any such hedge protects 100 percent of an investment from loss—particularly as it pertains to a CMBS transaction that, for example, is secured by a diverse pool of loans with exposure to different geographic locations, industries and property types. Therefore, loan securitizers that must satisfy a retention requirement continue to carry significant credit risk exposure that reinforces the economic tie between the securitizer and the issued CMBS even in the absence of any hedging constraints.

For these reasons, securitization reform legislation should not seek to prohibit securitizers from using market-oriented hedging vehicles. Instead, if a limitation is to be placed on the ability to hedge, it should be targeted to prohibit hedging any individual credit risks within the pool of risks underlying the securitization. Because these types of vehicles effectively allow the originator or issuer to completely shift the risk of default with respect to a particular loan or security, their use could provide a disincentive to engage in prudent underwriting practices—the specific type of disincentive policymakers want to address.

**Retroactive Changes to Securitization Accounting**

Beyond the specific securitization reform proposals that have been circulated by the Administration in draft legislation, there are two other policy initiatives that greatly concern CMSA because of the adverse effect these initiatives can have on the securitization market: retroactive changes to the rules for securitization accounting, and differentiated credit rating symbols for structured finance products.

Retroactive changes to securitization accounting rules known as FAS 166 and 167, which were recently adopted by the Financial Accounting Standards Board (FASB), throw into question the future of securitized credit markets. The new rules eliminate Qualified Special Purposes Entities (QSPEs), which are the primary securitization accounting vehicle for all asset-backed securities including CMBS, as well as change the criteria for the sales treatment and consolidation of financial assets. These accounting standards are important to issuers and investors, and for the liquidity of capital markets as a whole, because they free up balance sheet capacity to enable issuers to make more loans and do more securitizations, and they enable investors to invest more of their capital into the market. Under the new rules, however, issuers may not receive sales accounting treatment, while investors may be forced to consolidate an entire pool of loans on their balance sheet, despite owning only a small fraction of the loans pool.

The implementation date of FAS 166 and 167 is January 1, 2010, and it will be applied retroactively. The elimination of QSPEs therefore will impact trillions of dollars of outstanding asset-backed securities, including investors in these assets. These significant and retroactive changes will pose a serious threat to unlocking the frozen credit markets and another impediment to the Administration’s wide-ranging efforts to restart the securitized credit markets. CMSA and a diverse coalition of 15 trade groups have raised concerns about the timing and scope of FAS 166 and 167 given the impact these rule changes could have on credit availability. These concerns have been echoed by the Federal Reserve and other banking regulators, which wrote to FASB in December 2008 to highlight the adverse impact these rule changes could have on the credit markets.

More recently, Federal Reserve Board Member Elizabeth Duke capsulized the concerns shared by the industry when she cautioned that:

> if the risk retention requirements, combined with accounting standards governing the treatment of off-balance-sheet entities, make it impossible for firms to reduce the balance sheet through securitization and if, at the same

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2 More specifically, these two standards provide accounting guidance on when a sale of a financial instrument has occurred and how to account for the sale, and guidance on when a security issuer, B-piece buyer or servicer needs to consolidate the securities and liabilities on its balance sheet. The current rules facilitate securitization by allowing issuers to receive “sales treatment” for the assets they securitize, such that these assets are reflected on the balance sheet of the investors that purchase the bonds, rather than the issuers’ balance sheet. Moreover, under present rules, investors reflect only the fraction of the securitization deal that they actually own on their balance sheet.
time, leverage ratios limit balance sheet growth, we could be faced with substantially less credit availability. I'm not arguing with the accounting standards or the regulatory direction. I am just saying they must be coordinated to avoid potentially limiting the free flow of credit . . . . As policymakers and others work to create a new framework for securitization, we need to be mindful of falling into the trap of letting either the accounting or regulatory capital drive us to the wrong model. This may mean we have to revisit the accounting or regulatory capital in order to achieve our objectives for a viable securitization market. 3

Policymakers and standard setters, including FASB and the SEC, need to proceed cautiously and deliberately in this regard, so that accounting rule changes do not hamper the recovery of the securitization markets.

Credit Rating Agency Reform

One aspect of the reforms currently being considered for credit rating agencies is a previously rejected proposal to require credit ratings to be differentiated for certain types of structured financial products (requiring the use of “symbology,” such as “AAA.SF”). Generally speaking, “differentiation” is an overly simplistic and broad proposal that provides little value or information about credit ratings. Thus, CMSA’s members, and specifically the investors the symbology is geared to inform, continue to have serious concerns about differentiation, although we are strong supporters of more effective means of strengthening the credit ratings system in order to provide investors with the information they need to make sound investment decisions.

In fact, a broad coalition of market participants—including issuers, investors, and borrowers seeking access to credit—remain overwhelmingly opposed to differentiation because it will serve only to increase confusion and implementation costs, while decreasing confidence and certainty regarding ratings. Such effects would, in turn, create market volatility and undermine investor confidence and liquidity, which could exacerbate the current constraints on borrowers’ access to capital, at a time when other policymakers are employing every reasonable means to get credit flowing again.

In this regard, it is worth noting that the concept of differentiation has been examined extensively and rejected in recent years by the House Committee on Financial Services, as well as by the SEC and the ratings agencies themselves, 4 for most (if not all) of the foregoing reasons. Nothing has changed in the interim.

Accordingly, Congress should not include a differentiation requirement as part of any credit rating agency reform bill, but instead should include language consistent with that already passed last year by the House Committee on Financial Services in the Municipal Bond Fairness Act. That legislation would require CRAs to use ratings symbols that are consistent for all types of securities, recognizing the fact that a single and consistent ratings structure is critical to bond investors who want the ability to compare a multitude of investment options across asset classes. Ultimately, investors (who are critical to the Nation’s economic recovery) expect and demand a common rating structure to provide a meaningful foundation for our markets and ratings system. Such consistency will promote certainty and confidence among investors and all market participants.

In terms of credit ratings performance CMSA devoted significant resources over the last few years to affirmatively enhance transparency in credit ratings. Such enhancements will be far more effective in providing investors with the information they need to make the most informed decisions than a differentiated ratings structure. Instead of differentiated ratings, what CMBS investors have consistently sought is new, targeted transparency and disclosures about the ratings of structured products, to build on the already robust information CRAs provide in their published methodology, presale reports, and surveillance press releases.

In comments filed with the SEC in July 2008, CMSA listed a number of recommendations for enhancements that would serve the investor community, such as publication of more specific information regarding NRSRO policies and procedures related to CMBS valuations; adoption of a standard presale report template with

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4In early 2008, the CRAs sought feedback on various differentiation proposals, which elicited overwhelming opposition from investors. For example, see the results of Moody’s Request for Comment: “Should Moody’s Consider Differentiating Structured Finance and Corporate Ratings?” (May 2008). Moody’s received more than 200 responses, including ones from investors that together held in excess of $9 trillion in fixed income securities.
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 number one 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.
of many recently originated mortgages, including subprime 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.  

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 had about $16 of net assets for each dollar of capital. 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 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. 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 2-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 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 rebundled 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 nonuniformity hurt liquidity when the financial system was stressed.

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.

3 Source: SNL Financial, and company financials.

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 that 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; this total includes both revolving debt (i.e., credit-card loans) and nonrevolving debt (e.g., auto and student loans). Approximately 75 percent takes the form of loans on balance sheets of financial institutions, while the other 25 percent has been securitized. From 2005 through the third quarter of 2008, auto and credit card ABS issuance ranged between $160 billion and $180 billion per year. 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 loans provided by finance companies increased from 3.28 percent at end of July 2008 to 8.42 percent by the end of 2008.

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 percent 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, nonprime 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:

1. Loans on bank balance sheets: $3.5 trillion.
2. Agency MBS: $5.2 trillion.
   a. Fannie Mae: $2.7 trillion.
   b. Freddie Mac: $1.8 trillion.
   c. Ginnie Mae: $0.7 trillion.
   a. Prime: $0.6 trillion.
   b. Alt-A: $0.8 trillion.
   c. Subprime: $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 percent 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 reduction to be roughly 50 basis points. As of this week, the conforming-balance14 30-year fixed mortgage rate is approximately 4.85 percent, 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 1 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

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9 Source: Bloomberg.
12 Source: Loan Performance.
13 Source: JPMorgan, “Fact Sheet: Federal Reserve Agency Mortgage-Backed Securities Purchase Program”.
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.
16 Source: Loan Performance.
17 Source: Loan Performance.
market may have 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, 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 to millions of 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.

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.

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Prepared Statement of the Mortgage Bankers Association

The Mortgage Bankers Association (MBA) appreciates the opportunity to provide this statement for the record of the Senate Banking, Securities, Insurance, and Investment Subcommittee hearing on the securitization of assets.

Asset-backed securities are a fundamental component of the financial services system because they enable consumers and businesses to access funding, organize capital for new investment opportunities, and protect and hedge against risks. As policymakers evaluate securitization’s role in the recent housing finance system’s disruptions, MBA believes it is important to keep in mind the benefits associated with securitization when it is used prudently by market participants.

Securitization describes the process in which relatively illiquid assets are packaged in a way that removes them from the institution’s balance sheet and sold as more liquid securities. Securities backed by residential or commercial mortgages are an example of asset securitization.

Securitization is an effective means of risk management for many institutions. For example, the accumulation of many loans in a single asset sector creates concentration risk on a financial institution’s balance sheet. If that sector becomes distressed, these large concentrations could place the solvency of the financial institution at risk. However, securitization provides a remedy to avoid concentration risk by disbursing the exposure more widely across the portfolios of many investors. In this way, the exposure of any one investor is minimized. As demonstrated by the current business cycle however, if the entire system is hit by a significant systemic shock, all investors will face losses from these exposures, as diversification does not protect investors from systemic events.

Securitization also enables various market sectors to create synergies by combining their particular areas of expertise. For example, community-based financial institutions are known for their proficiency in originating loans because of their relationships with local businesses and consumers, and their knowledge of local economic conditions. Securitization links these financial institutions to others that may be more adept at matching asset risks with investor appetites.

As the last 2 or 3 years have demonstrated, when it is not understood, or poorly underwritten, securitization can cause meaningful harm to investors, lenders, borrowers and other segments of the financial services system. Since the economic and housing finance crisis began, investors have shunned securitization products, including mortgage-backed securities (MBS), particularly those issued by private entities. As a result, central banks and governments have taken up the slack with various programs to support securitization markets. MBA believes this has been an important, yet ultimately unsustainable, course of action.

When considering how to reestablish a safe and sound environment for securitization of real estate-related assets, MBA believes the following components must be addressed:

- **Risk Assessment:** Risk assessment is an imperfect science, but it is crucial for securitization to enable accurate, effective, and stable risk assessment. Equally important, third-party assessments of risk must be highly credible to be widely used or adopted.

The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, DC, the association works to ensure the continued strength of the Nation’s residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA’s Web site: www.mortgagebankers.org.
alties. Loan attributes, such as whether a loan is adjustable-rate or fixed rate, or does or does not have a prepayment restriction, shift risks between the borrower and the investors. If investors or other market participants are not accountable for the risks they take on, they are prone to act irresponsibly by taking on greater risks than they otherwise would.

• **Aligning Rewards With Long-Term Performance:** Given the long-term nature of a mortgage contract, as well as the imperfect state of risk assessment, some risks inherent in a mortgage asset may not appear for some time after the asset has changed hands. It is important to consider the degree to which participants in the mortgage process can be held accountable for the long-term performance of an asset.

• **Ensuring Capital Adequacy of Participants:** Participants throughout the market need adequate levels of capital to protect against losses. Capital adequacy is keenly dependent on the assessment of risks outlined above. The greater the risks, as assessed, the greater the capital needed. In times of rapid market deterioration, when model and risk assumptions change dramatically, capital needs may change dramatically as well. If market participants that have taken on certain risks become undercapitalized, they may not be able to absorb those risks when necessary—forcing others to take on unanticipated risks and losses.

• **Controlling Fraud Between Parties in the System:** A key consideration for effective securitization is the degree to which fraud can be minimized. Key considerations include the ability to identify and prosecute fraud, and the degree to which fraud is deterred.

• **Transparency:** In order to attract investors, another key consideration for securitization is transparency. The less transparent a market is, the more poorly understood it will be by investors, and the higher will be the yield those investors demand to compensate for the uncertainty.

The task of improving transparency and accountability involves both policy and operational issues. Public debate typically focuses on the policy issues—what general types of information should be disclosed, and who should share and receive this information. However, the operational issues are equally important to establishing and implementing a functional system that promotes and supports the goals of transparency and accountability. We are submitting testimony today to stress the importance to market transparency and investor confidence of better loan tracking and more accessible, complete, and reliable loan and security data across the primary and secondary mortgage markets.

**Loan and Security Tracking**

Improving transparency in the real estate finance system is considered essential to restoring investor confidence in the securitization market. Because the real estate finance system embraces multiple parties—loan originators, loan aggregators (servicers) and securitizers—we need transparency solutions that flow from and span the complete mortgage value chain.

The goal, we think, is relatively easy to state: key information about mortgages, the securities built upon those mortgages, and the people and companies that create them, should all be linked and tracked over time, so our financial system is more transparent and the strengths and risks of various products can be properly assessed and appreciated. Loans need to be tracked, for example, to help identify fraud and distinguish the performance of various mortgage products and securities types.

Just as the vehicle identification number, or “VIN,” has evolved from a simple serial number into a valuable tool for consumers, enabling a potential purchaser to research the history of any car or truck, a comprehensive mortgage/security numbering system would be the key to tracking MBS history and performance.

Achieving such a goal is very doable because the essential components are already in place. With relatively minor modifications these existing systems can evolve into the tools necessary to meet the challenge of transparency and accountability.

On the mortgage end of the value chain there is **MERS.** This national loan registry is already used by virtually all mortgage originators, aggregators, and securitizers to track individual mortgages by means of a unique, 18-digit Mortgage Identification Number, or “MIN.” For each registered mortgage, the MIN and the MERS database tracks information regarding the originator, the borrower, the prop-

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2“MERS” is formally known as MERSCORP, Inc., and is the owner and operator of the MERS® System. MBA, along with Fannie Mae, Freddie Mac, and other industry participants, is a shareholder in MERS.
MISMO is a wholly owned subsidiary of the Mortgage Bankers Association. On the securitization end of the value chain, the American Bankers Association has a product called CUSIP that generates a 9-digit identification number for most types of securities, including MBS. The CUSIP number uniquely identifies the company or issuer and the type of security instrument.

Together, these two identifiers solve the loan and security tracking problem, with the MIN tracking millions of individual mortgage loans and the CUSIP tracking thousands of unique financial instruments created each year in the United States. Loan-level information for every mortgage and mortgage-backed security would be available at the touch of a button, for example, the credit rating agencies would have needed information to assess more accurately the risk of a given security and track its performance relative to other securities over time.

As the Congress looks to reform the capital markets, it should require that these two complementary identification systems be linked and that they be expanded in scope to track the decisions of all market participants—originators, aggregators and securitizers. In this way, throughout the value chain, participants that contributed to the creation of high-risk mortgages and selling of high-risk securities may be identified and held accountable.

With a system like this in place, the Congress, regulators and the market as a whole would have a means of distinguishing with much more precision the quality of financial products and could enforce the discipline that has not been previously possible.

**Data Standards**

The Mortgage Industry Standards Maintenance Organization, Inc. ("MISMO®") has been engaged for the past 8 years in developing electronic data standards for the commercial and residential real estate finance industries. These standards, which have been developed through a structured consensus-building process, are grounded in the following principles that we believe characterize a robust, transparent system of data reporting:

- First, there must be concrete definitions of the data elements that are going to be collected, and these definitions must be common across all the related products in the market. Different products (such as conforming and nonconforming loans) may require different data elements, but any data elements that are required for both products should have the same definitions.

- Second, there should be a standardized electronic reporting format by which these data elements are shared across the mortgage and security value chain and with investors. The standards should be designed so that information can freely flow across operating systems and programs with a minimum of reformatting or rekeying of data to facilitate desired analytics. Rekeying results in errors, undermining the reliability of data. MISMO’s standards are written in the XML (Web based) computer language. This is the language used in the relaunch earlier this week of the Federal Register’s Web site. As reported in The Washington Post on October 5, 2009, this Web site has been received with great praise for allowing researchers and other users to extract information readily from the Register for further analysis and reuse without rekeying. Mortgage and securities data transmitted using MISMO’s data standards can similarly be extracted and used by investors and regulators for customized analytics. XML is also related to and compatible with the XBRL web language that the Securities and Exchange Commission (SEC) is implementing for financial reporting.

- Third, the definitions and the standards should be nonproprietary and available on a royalty-free basis, so that third-parties can easily access and incorporate those standards into their work, whether it be in the form of a new loan origination software package or an improved analytical tool for assessing loan and security performance or fraud detection.

- Fourth, to the extent that the data includes nonpublic personal information, the system must maintain the highest degree of confidentiality and protect the privacy of that information.

True transparency requires that information is not only available, but also understandable and usable. The incorporation of these four principles into any new data standards would greatly enhance the ability of Congress, regulators, and investors to understand and use the information generated by the financial markets.

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3 MISMO is a wholly owned subsidiary of the Mortgage Bankers Association.
reporting regime will help ensure that the goal of transparency and accountability is realized.

We believe that the standards of MISMO and MERS satisfy these elements for the conforming mortgage market. Their relative positions in the real estate finance process provide them with unique insight and an objective perspective that we believe could be very useful to improving transparency and accountability in the non-conforming market.

Increasing the quality and transparency of loan-level mortgage and MBS-related data is an essential step so that investor confidence may be restored and the risk of a similar securitization crisis of the kind we are experiencing in the future can be minimized. This objective is paramount to all market participants, and as such all participants have an interest in achieving a solution. However, because it is so critical, the ultimate solution must also be able to withstand the scrutiny of investors, Government regulators, and academics. It must be widely perceived as a fair, appropriate, and comprehensive response to the challenges at hand.

In conclusion, MBA reiterates its request for Congress and other policymakers to be mindful of the important role of securitization to housing finance and the entire financial services system. As the Congress looks to reform the capital markets, we look forward to working with you to developing a framework with a solid foundation based on the key considerations outlined above.