



July 21, 2010

VIA E-MAIL to [Mortgage\\_Conference\\_Submission@frbchi.org](mailto:Mortgage_Conference_Submission@frbchi.org)

Federal Reserve Bank of Chicago  
Mortgage Foreclosures and the Future of Housing Finance  
Submission of the American Securitization Forum

**Re: Mortgage Foreclosures and the Future of Housing Finance  
Reform of the Housing Finance System**

The American Securitization Forum (the "ASF")<sup>1</sup> submits this letter in response to the Call for Papers issued jointly by the Federal Reserve System ("Federal Reserve") and the Federal Deposit Insurance Company ("FDIC"). As the Federal Reserve and the FDIC are co-hosting a two-day conference (the "Conference") regarding the future of the U.S. housing and mortgage market, the ASF would like to volunteer to organize and/or participate in a policy-oriented panel relating to the role of securitization in a stable and sound housing finance system.

We appreciate the enormous scope of the topics the Federal Reserve and the FDIC are preparing to address at the Conference, which we see as fundamental not only to the mortgage finance, housing and securitization markets, but also to the global financial markets and the U.S. economy.

We would also like to note that our membership and our expertise reflects that of the securitization industry, and we are not in a position to address many of the aspects of the housing finance system that will undoubtedly be considered at the Conference. However, because the bulk of housing finance takes place in the capital markets, via securitization through either the government-sponsored enterprises (the "GSEs") or the private label market, we feel it is appropriate for the ASF to offer to participate in the Conference. We believe that our participation will be consistent with one of the ASF's core values: "to improve the long term health and vitality of the securitization market, and to advance the greater good that securitization provides to consumers, businesses and the economy."

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<sup>1</sup> The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests in important legal, regulatory and market practice issues. ASF members include over 340 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. The ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to <http://www.americansecuritization.com>

Our proposed topic for a Conference panel is “The Role of Securitization in the Housing Finance System.” Set forth below are some of our preliminary thoughts regarding the types of issues which the panel would discuss.

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As a preliminary matter, we believe it would be helpful to provide a brief review of several aspects of the nation's housing finance system. In this regard, it is useful to begin with the very basics: the nature of the housing stock, and how it is financed.

The nation's housing stock consists of various types of physical assets: single-family detached homes, townhouses and multifamily structures, which run the gamut from small, owner-occupied and managed two-to four-family structures to the 15,372-unit Co-op City development in the Bronx, New York City. One common characteristic all of these different types of housing structures share is that they are all capital assets, the construction or purchase of which is most appropriately financed through medium or long term debt secured via a security interest in the related real property. Put more simply, the nation's method of financing its aggregate housing stock is via mortgage finance.

A mortgage loan consists primarily of two distinct instruments: a promissory note, which represents the borrower's obligation to pay and a mortgage, deed of trust or long-term lease type document, which creates a security interest in the property that can be enforced by the lender in the event of a borrower default on the note. The note is a fixed-income instrument, suitable for investors seeking a fixed-income return. These investors may be individuals, banks and other financial institutions such as insurance companies, pension funds, the GSEs, or the U.S. Treasury.

#### A. Government Securitizations.

Prior to the 1970's, the primary source of residential mortgage credit was savings and loan associations. These "thrifts" originated and serviced mortgage loans, and generally held them in their portfolios until maturity or prepayment. The funding for these portfolios was primarily savings deposits.<sup>2</sup>

The consequences of this non-securitized portfolio lending strategy included:

- localized markets, with a high degree of variation in rates and the availability of credit;
- sensitivity on the part of the thrifts to the mismatch between the short-term funding provided by deposits and the long-term (fixed rate) mortgage loans; and
- concentration of mortgage risk in a single industry (thrift industry).

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<sup>2</sup> See, generally, Lewis S. Ranieri, “The Origins of Securitization, Sources of Its Growth, and Its Future Potential”, in A Primer on Securitization, eds. Leon T. Kendall and Michael J. Fishman (Cambridge, MA.: The MIT Press, 1996).

All of these consequences added up to a market which was limited, segmented and unpredictable, in turn inhibiting the growth in home ownership.

The thrifts' "originate and hold" strategy also had the effect of vertically integrating in a single industry the three principal economic components of mortgage finance. The thrift was the originator of the mortgage loan, the servicer of the mortgage loan and the long term financier of the mortgage loan. The first two of these components are active businesses, requiring management skills and contact with consumer. The third component is essentially passive and requires certain skills relating primarily to the management of financial risks.

These elements of the housing finance system began to change in the 1970's when the "Agency" or GSE market began to develop rapidly. Although government support for the residential housing finance market dates to the Depression, with the establishment of the Federal Housing Administration ("FHA") in 1934, and the Federal National Mortgage Association ("Fannie Mae") in 1938, prior to the 1970's the government's support was primarily limited to loan-level guarantee programs. Fannie Mae was partitioned in 1968 into two parts: the Government National Mortgage Association ("Ginnie Mae"), a federal agency, and a federally-chartered but shareholder owned enterprise still known as Fannie Mae. The Federal Home Loan Mortgage Corporation ("Freddie Mac"), another federally-chartered, shareholder owned enterprise was created in 1970, primarily to serve the thrift industry.

The earlier government support mechanism of loan-level insurance through the FHA and the Veterans' Administration (the "VA"), although encouraging thrifts and other lenders to make loans which they otherwise would not, did not fundamentally impact the "originate and hold" strategy. The disaggregation of the three economic components of mortgage finance was however, greatly facilitated by the GSEs' creation and participation in the secondary mortgage market.

The "disaggregation" is one of the principal benefits of securitization, as it permits banks and other finance companies to focus on what they do best – originate and service loans. Disaggregation further provides for more efficient matched funding, via the capital markets, for the fixed income instruments which comprise the mortgage notes. Since the underlying fixed income instruments are generally of fairly long term (fifteen to thirty years) a capital market execution also permits time tranching, providing the opportunity for investment at all points along the yield curve, as well as credit tranching, to permit investment all at points along the risk/return spectrum. All of these aspects combine to make securitization the most efficient method of financing the capital assets which make up the nation's physical housing stock, from single-family detached homes to the largest multi-family complexes.<sup>3</sup>

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<sup>3</sup> The economic benefits of securitization have been the subject of many academic and scholarly articles. These articles generally have concluded that securitization has positive impacts on the cost and availability of credit, as well as on the dispersion of risk. One recent study, "Study of the Impact of Securitization on Consumers, Investors, Financial Institutions and the Capital Markets" (June 17, 2009), (hereafter, the

## B. Private Label Securitizations.

The GSEs have been limited by their charters to the purchase and finance of the "conforming" part of the market, defined primarily by certain credit and documentation standards (such as loan to value ratio), and subject to maximum principal balance limitations. The non-conforming loan mortgage market (the "private label" market) also dates from the 1970's. It really began to come into its own, however, following the passage of the real estate mortgage investment conduit ("REMIC") legislation in 1986. The private label market serves both the "jumbo" (loans with principal balances in excess of the conforming loan limits) and the "subprime"/"Alt-A" markets (loans which do not meet other standards set by the GSEs).

As a result, from effectively zero in 1970, the percentage of residential mortgage loans securitized in 2007 was roughly 60% for conforming loans, roughly 75% for jumbo loans and roughly 100% for sub-prime loans.<sup>4</sup>

## C. The Market Since Financial Crisis.

With the virtual disappearance of the private label market since the onset of the financial crisis, the residential mortgage market has become essentially a government market, with close to 99% of all new residential mortgage finance transactions being through Fannie Mae, Freddie Mac and FHA/VA.<sup>5</sup>

The recent history (at least since the REMIC legislation) of the US housing finance market reveals two broad trends:

- securitization has largely displaced portfolio lending; and
- private label (non-government) securitization grew relative to Agency securitization.

Since the beginning of the financial crisis the first of these trends has accelerated while the second has broken down. Previously dominant private market participants have withdrawn. The GSEs, as mandated by their charters, have not. The GSEs have continued to support liquidity in the secondary mortgage markets by buying into supply when demand is low. Consequently, the market has been able to operate by becoming a government market in terms of issuance and insurance, and largely a government market in terms of portfolio holdings. The ASF's view is that the smooth functioning of the housing finance sector of the U.S. financial market is a national priority and the government's dominant role in the U.S. housing finance system during the recent crisis was both necessary and appropriate.

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“NERA Study”) was produced by National Economic Research Associates, Inc. at the request of the ASF, and is available at [www.americansecuritization.com/uploadedfiles/ASF\\_NERA\\_Report.PDF](http://www.americansecuritization.com/uploadedfiles/ASF_NERA_Report.PDF)

<sup>4</sup> NERA Study, p. 25.

<sup>5</sup> American Banker article, “Fannie, Freddie and Ginnie at Nearly 100% Market Share”, June 2, 2010.

The commercial real estate market provides guidance as to what might have happened to the residential real estate market in the crisis, but for the government's involvement: Generally speaking, the commercial real estate and mortgage markets have not received widespread government support, with the result that credit is unavailable for most types of properties (other than multifamily properties, which are supported to some extent by the GSEs). Much of that market has become an "all cash" market and commercial real estate prices in many areas are currently down to 30-40% of replacement cost. Residential real estate has also suffered a substantial loss of value, particularly in several previously overheated markets.<sup>6</sup> However, the decline in home values, while severe in some markets, has been mitigated across the country by the availability of mortgage credit.

#### D. The GSEs.

*GSE Securitizations.* Throughout the financial crisis, the US residential real estate finance market has been financed not only through the government support but also through securitization. Technically, this is because securitization is a nothing more than a financing technique; a government or GSE securitization is still a securitization. A government securitization, however, carries with it a government guarantee, making government securitization fundamentally different from a private label securitization. This is because a government securitization poses, on the investor side, a more narrow set of risks (prepayment, currency and interest-rate) than do private label securitizations, which of course have all those risks plus credit risk, as well as (arguably) more legal and regulatory risks. Of course credit, legal and other risks do not disappear in government securitizations, they merely do not fall on the investors, but rather on the government and thus, ultimately, on the taxpayers. But in terms of structure, disclosure, the need for registration of securities, and various other issues, it appears that the government securitization market is so substantially different from the private label securitization market that the same practices and procedures need not necessarily apply to both markets. Put another way, the government securitization market is more like the Treasury market, and the private label market is more like the corporate bond market.

Another way to view the government securitization market is that its defining characteristic is less its securitization aspect, and more its guarantee aspect. If government securitizations are "secured Treasuries" they should theoretically trade at spreads comparable to Treasuries. That has not proven to be the case, suggesting that perhaps the prepayment and interest-rate risk associated with the actual, underlying mortgage pool creates more distraction than benefit to the investor community.

*The TBA Market.* The conducting observation of the prior section is demonstrated most dramatically when considering the "To-Be-Announced", or "TBA" market, for GSE MBS. A TBA is a contract for the purchase or sale of GSE MBS (e.g., \$50 million of 5½% Fannie Mae MBS due in 2040) to be delivered at a future, specified date,

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<sup>6</sup> See, generally, The Congressional Oversight Panel's February 2010 Report, "Commercial Real Estate Losses and the Risk of Financial Stability", pages 27-36, <http://cop.senate.gov/documents/cop-021110-report.pdf>

sometimes substantially (up to 90 days) in advance of the settlement date. At the time of trade, however, neither the exact pool, number of pools, or loans comprising the pool are known; rather the trade, and in fact this entire market, is made possible only because of the fundamental assumption of the essential homogeneity and the fungibility of GSE MBS.

The TBA market thus allows originators to hedge and fund their forward origination pipelines, since they can originate loans (*i.e.*, "lock in" the rates and prices on the loans) during the period between the trade and the settlement dates.

It is worth noting that what makes the TBA market possible – its homogeneity – is a result of two underlying factors, first, the fungibility of the conforming loan product, which is a standardized product with established and uniform underwriting guidelines and form documentation, and, second, the effect of the GSE guaranty, which equalizes all of the securitized MBS in terms of credit risk. In other words, it is probably not possible that the TBA market could be replicated outside of the GSEs, or outside of some replacement of the GSEs that, itself, was able to replicate the two underlying factors of fungible product and uniform credit risk across different originators.

We also observe that many of the reforms being suggested with regard to the private label MBS market – most notably, perhaps, the furnishing of enhanced loan-level data to investors – is inconsistent with the operation of the TBA market, since its unique characteristic is that the underlying loans need not even be identified as of the trade date. This again suggests that a uniform disclosure and registration requirement for GSE and private label MBS may come at a heavy cost.

Any GSE "reform" which does not accommodate, or suitably replace, the existing GSE MBS TBA market will undoubtedly impact mortgage originators both severely and negatively by reducing the originators' options to "rate lock" and thus satisfy consumer needs. As is always the case, these impacts will surely disproportionately fall on the nation's smaller finance companies as well as the community bank sector.

*The GSE Portfolios and Securitization.* Many commentators have raised questions regarding the policy behind the practice of the GSEs to maintain portfolios.<sup>7</sup> These portfolios consist of both whole loans as well as private label MBS and GSE MBS. The ASF expects this practice of the GSEs to be one of the principal areas of focus as the government undertakes its review of federal housing policy.

Those who are critical of the GSE portfolios frequently suggest that the practice results from the GSEs' historical structure as private, stockholder-owned entities. Under this line of reasoning, enterprise profits can be enhanced with a business strategy of borrowing at a relatively low rate, and investing the proceeds of the debt in higher yielding assets. More specifically, these commentators allege that the GSEs can issue debentures at a taxpayer subsidized rate, and then manufacture arbitrage profits which

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<sup>7</sup> See, by way of illustration, Dwight M. Jaffee of the University of California at Berkeley, "On Limiting the Retained Mortgage Portfolio's of Fannie Mae and Freddie Mac", June 30, 2005, <http://fic.wharton.upenn.edu/fic/papers/05/0538.pdf>

accrue, not to the taxpayers who make it all possible, but to the far more limited universe of GSE shareholders. Ancillary arguments along these same lines suggest that the GSEs may also engage in relatively risky hedging strategies in an attempt to preserve these arbitrage profits.

Thus, the issue of the GSEs' portfolios is frequently linked as well as to the issues of private ownership of the GSEs and the related profit-maximizing behavior, the suggestion perhaps being that, in the absence of private ownership, there would be no inclination to generate the alleged arbitrage profits and thus no inclination to maintain portfolios. As a consequence, those commentators conclude that the GSEs should perhaps be limited solely to their guarantor function (like Ginnie Mae) and prohibited from maintaining portfolios.

These are very difficult arguments to address, because it is impossible to separate out the two fundamental strains of reasoning supporting the argument: one based on the profit-maximizing inclination of privately owned enterprises, and one based on an alleged misuse of a taxpayer-supported benefit. The ASF is certainly not today in a position either to support or criticize the practice of maintaining GSE portfolios.

We would urge the government in considering this complex issue to keep in mind two very broad principles. First, the recent financial crisis has demonstrated that anything which maximizes the options available to the government is probably a positive rather than a negative, under the general proposition that more options are better than fewer.

What follows from this first principle is that any hard and fast policy prohibiting the maintenance of GSE portfolios is also a policy which narrows the universe of available options. The maintenance of portfolios is not necessarily inexorably linked with the question of private versus public, or some sort of hybrid ownership structure.

Our second observation is that the maintenance of GSE portfolios funded by GSE debentures tends to retain relatively more risk on the GSEs and their owners than do GSE securitizations (i.e., transactions in which the GSEs act only as guarantors). To the extent that the maintenance of the portfolios arguably give rise to "arbitrage profits", it is useful to remember that profits are economically the flip side of risk, which in the case of the GSE portfolios are primarily prepayment and interest rate risks. A GSE securitization strategy, as compared to a GSE portfolio strategy, will tend to transfer both prepayment and interest rate risk to the investors, rather than retain these risks at the GSEs and their owners; this is true whether those owners are private shareholders, the government, or some hybrid.

#### E. The Private Label Securitization Market.

An important element of government housing policy is the regulatory architecture governing securitization. As is well known, the financial crisis has precipitated a number of reform proposals. The government has issued several proposed rules, and the securitization industry has developed a variety of initiatives, aimed at both the securitization market and the broader structured products industry. The ASF will

comment on many, if not all, of the government proposed rule-makings. Consequently, we will not repeat here our observations on those more targeted letters, but rather will set forth our views on several fundamental points, in particular:

- much of the source of financial crisis seems attributable to an overheated real estate market; and
- a rising real estate market increases lenders' willingness to provide credit, and borrowers' willingness to take on debt.

*The Structure of Mortgage Credit as a Fixed-Income Investment.* With respect to the residential mortgage sector, there are generally considered to be two aspects to a lender's underwriting analysis: the borrower's ability to repay, and the likelihood that the collateral value of the real estate will be sufficient to satisfy the debt in the event of a borrower default. This point is driven home with particular clarity in so-called "single-action" states, where, by law, upon a borrower's mortgage default, the lender must choose between an action against the borrower on the note (*i.e.*, an action against the borrower's personal credit) and on action against the mortgaged property (*i.e.*, foreclosure and sale). Not surprisingly, and, indeed, entirely sensible is the phenomenon that a lender would be more inclined to extend credit on a secured loan (such as a mortgage) when the value of the collateral is, by all available indications, on the rise. Put another way, if a loan is secured by both personal credit and collateral, a strong collateral position will put a lender in a position to make more accommodations regarding the borrower's personal credit strength, and vice-versa. Consequently, one would expect relatively more emphasis on collateral value when collateral values are rising, and less emphasis on personal credit.

Securitization, as a technique, works best when the underlying assets are themselves debt or debt-like instruments with predictable and scheduled cash flows. The securitization technique also works with less predictable cash flows, for example, the case of "liquidating trusts" where the assets are, from the outset, foreclosed or seriously delinquent real estate properties. In these structures, however, the securitization's cash flows become relatively unpredictable, and time and credit tranching become difficult since recovery periods and rates are uncertain. As a result, the securities issued in a liquidating trust structure tend to be on the more speculative side of fixed-income investments – in effect, equity type investments structured as fixed-income investments. As a general principle of finance, the difference between equity investments and fixed income investments is rather fundamental, so any misapprehension (or outright confusion) as to whether an investment is an equity versus a fixed-income investment is likely to lead to substantial mis-pricing and inefficiency. An investment backed by real estate properties would generally be considered an equity type investment, whereas an investment backed by promissory notes would generally be considered a fixed income investment – the investments in effect take on the character of the underlying assets which service the investment. Thus investments which rely heavily on "the future" and/or "management" are essentially equity investments not ideally suited to classical securitization.

What this line of reasoning means for government policy in the housing finance system is simply this: state or federal law policies which relieve consumers from personal liability for mortgage debt, such as a "single-action" rules, tend to make residential real estate lending relatively more like equity and relatively less like debt. Since the securitization market is at its most efficient as a fixed-income market, then, other things being equal, the more emphasis there is on borrower credit, as represented by the promissory notes, and the less emphasis there is on the real estate, the more efficient the securitization structure becomes.

Many commentators on the recent crisis acknowledge the contributing roles of the real estate bubble and of the securitization market, and also the likely fundamental truth that bubbles will always be with us, and they can only be seen, at least by most of us, when they pop. Hence in the narrow area of real estate finance, the best solution is probably a structural one, to encourage both borrowers and lenders to focus relatively more on personal credit, and relatively less on real estate values, thus helping to re-order the housing finance system, at least as regards securitization, more strongly to a proper fixed-income market.

*General Regulatory Uncertainty.* Today, the President just signed the Dodd-Frank Act, which impacts the securitization markets primarily through the risk retention and credit rating agency reform provisions, although other aspects of the Act, particularly as regards resolution regimes for financial institutions and consumer protection, also have the potential for huge, if indirect, impacts on this market. Many important details of implementation have been left to a variety of federal agencies, including the SEC, HUD, the FDIC, the Federal Housing Finance Agency, the OCC and the Federal Reserve. The legislation mandates various time frames for regulations, generally one or two years following enactment. In addition, both the previously-introduced covered bond legislation, as well as the not-yet taken up issue of GSE reform have the potential to alter vastly the regulatory landscape for the securitization industry.

Apart from this legislation, the SEC has recently promulgated a variety of new regulations regarding credit rating agencies and the ratings of "structured finance products", and is in the process of revising the principal regulation relating to securitizations, Regulation AB -- a process that will likely continue for another six months to a year.<sup>8</sup> Meanwhile, the FDIC is currently in the process of revising its legal isolation safe-harbor regulation for securitizations, 12 CFR 360.6, primarily in response to accounting changes which themselves remain in flux.<sup>9</sup>

With regard to the judicial system, recent court decisions as well as pending cases also add to the pervasive sense of uncertainty in the securitization markets. Among the more notable cases are the Dante<sup>10</sup> and Metavante<sup>11</sup> decisions from the Lehman bankruptcy,

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<sup>8</sup> Securities Act Release No. 9117 (April 7, 2010), published in the Federal Register on May 3, 2010.

<sup>9</sup> Federal Register, Vol. 75, No. 94, May 17, 2010, p. 27471.

<sup>10</sup> See "Bankruptcy Judge Invalidates Securitization Payment Structure", HousingWire, January 29, 2010, <http://www.housingwire.com/2010/01/29/bankruptcy-judge-invalidates-securitization-payment-structure>.

<sup>11</sup> See "The Specter of Lehman Shadows Trade Partners", Wall Street Journal, September 17, 2009, <http://online.wsj.com/article/SB125313981633417557.html>

the General Growth Properties ruling regarding the "adequate protection" doctrine in bankruptcy,<sup>12</sup> and the SEC's action against Goldman Sachs relating to disclosure issues in the Abacus CDO transaction.<sup>13</sup>

It goes without saying that all of these legislative, regulatory and judicial actions are important and well-merited in their own right, and that the issues are complex and require both time and substantial thought. Nevertheless, that having so many different bites being taken at essentially the same apple by so many different governmental bodies – and indeed, different branches of government – is not a recipe for a quick revival of the securitization markets and/or the nation's system of housing finance. Government officials from the Treasury Secretary<sup>14</sup>, the Federal Reserve Chairman<sup>15</sup> and the FDIC Chairman<sup>16</sup> on down have all made the point that a revival of the securitization markets is a necessary condition to a revival of the U.S. economy. Given all the different tracks on which these government actions are currently traveling, the visible supply of legal and regulatory uncertainty extending out over the securitization markets for the next two years at least seems to indicate that a full economic recovery is also at least that far off.

In light of this, the ASF strongly believes that federal housing finance policy should work to restart the non-agency residential mortgage secondary market in a rational and coordinated way. Regulatory uncertainty, among other things, is presently frustrating the ability of originators to develop a sound business strategy in the non-conforming product. Market regulation of securitization transactions should promote a sustainable non-agency securitization market. This should be done in a collaborative and coordinated way, which facilitates the core credit intermediation functions of banking organizations. We believe that a single, national standard arising out of the Dodd-Frank Act, and implemented by joint interagency regulatory rulemaking will best achieve the housing finance policy goals of promoting responsible underwriting and market transparency, while addressing the need of industry participants to have a clear, practical and efficient approach. A fragmented approach to regulating these markets, in which various regulatory bodies (and, indeed, all three branches of government) develop slightly different rules governing the exact same subject matter, is unlikely to produce efficient results and prove to be a drag on the mortgage market.

Risk retention mandates associated with residential mortgage credit risk need to be practical and flexible, and need to recognize that there are many paths to the mountaintop. Various policy proposals have been advanced by Congress (through the Dodd-Frank Act), the FDIC, the SEC, and others. While each proposal addresses the

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<sup>12</sup> See "General Growth: Bankruptcy and the Downfall of Securitization as We Know It", (Westlaw Business, Legal Currents, May 5, 2009,

[http://currents.westlawbusiness.com/Articles/2009/07/20090728\\_0053.aspx?cid=&src=](http://currents.westlawbusiness.com/Articles/2009/07/20090728_0053.aspx?cid=&src=)

<sup>13</sup> See "SEC Split Over Goldman Deal", Wall Street Journal, July 17, 2010,

<http://online.wsj.com/article/SB10001424052748704229004575371601322076426.html>

<sup>14</sup> Secretary Geithner's remarks on "Meet The Press", March 29, 2009, reported at

<http://seekingalpha.com/article/128432-straight-talk-from-geithner-on-securitization>

<sup>15</sup> Chairman Bernanke quoted at the Federal Reserve Bank of Chicago meeting's question and answer session, May 6, 2010, reported at <http://www.reuters.com/article/idUSWEN433720100506>

<sup>16</sup> Chairman Bair's remarks to the Housing Association of Non-Profit Developers Annual Meeting, Tyson's Corner, Virginia, June 7, 2010, <http://www.fdic.gov/news/news/speeches/chairman/spjun0710.html>

same subject matter and each shares certain elements, these proposed standards are all different. To the extent that risk retention is required, the Dodd-Frank Act authorizes regulators to determine whether it is to be accomplished in a particular way such as for example a pro-rata vertical slice, a first-loss interest, holding similar loans on balance sheet in unsecuritized form, or other reasonable methods. High-quality qualified residential mortgages will be exempt. Also, reasonable standards concerning sunset provisions and permitted hedging should be considered. Further study should be undertaken to determine how best to approach risk retention, its consequences to balance sheets and bank capital, as well as a review of its potential macroeconomic effects. A “one-size-fits-all” approach is unlikely to produce the best results.

As the markets heal, private organizations should increasingly be encouraged to participate in the non-agency securitization markets. If banks continue to refrain from non-agency securitization activity, concentrations of mortgage credit risk appear likely to continue to reside within the FHA and Ginnie Mae, within the GSEs, and with other governmental or quasi-governmental bodies. Responsible, user-friendly non-agency securitization markets should be viewed as a tool to help gradually reduce concentrations of these risks in governmental agencies, as well as transferring these risks outside of the banking system.

To the extent the process of resolving the legal and regulatory uncertainties surrounding securitization can be co-ordinated and (not unduly) accelerated, the revival of the housing finance system and of the U.S. economy in general will happen sooner rather than later.

#### F. Insights From Other Jurisdictions.

The ASF strongly supports the view that the US should consider systems, and individual aspects of systems, of housing finance from other jurisdictions. Three broad areas for consideration suggest themselves:

- different cultural notions of the desirability of home ownership;
- with respect to residential housing finance, product offerings and imbedded issues of risk allocation; and
- alternative securitization products, and covered bonds in particular.

*Home ownership.* Treasury, and HUD have solicited public comment on the issue of a federal housing policy for "sustainable home ownership". This is perhaps the broadest of the questions posed by the notice, and although, once again, the ASF has no special wisdom on this bedrock issue, we will offer some broad observations on home ownership, consumer credit and the capital markets.

As noted earlier in this letter, there are three basic forms of the hard assets which make up this nation's or any nation's physical housing stock: single-family detached, townhouse and multifamily (both small and large complexes). Although "home ownership" is not synonymous with "single-family" detached homes, there is enough truth to that to make it

useful to see the two things as synonymous. Viewing the issue a different way, however, leads to considering the home ownership issue not as an issue of the type of housing unit; but rather as the "owner" versus the "renter" model, where the primary difference, arguably is whether the unit's inhabitant has any equal investment in the "bricks and mortar" which make up the unit. In many people's minds, these two different ways of seeing "home ownership" collapse, and become fused in the notion that one "buys a home" (single-family detached or townhouse) and one "rents an apartment".

Certainly the notion that home ownership is a desirable goal seems deeply imbedded in the yet broader notion of the "American Way of Life". This notion serves as the marketing principle for both the GSEs as well as many depository and non-depository lenders.

Beyond "home ownership" as a marketing principle for the residential mortgage industry, such a principle fits in nicely with the even broader concepts of consumer spending and consumer credit. It seems commonsensical to conclude that there is probably some sort of a direct correlation between the size of one's housing unit (or units) and one's appetite for spending on large purchases such as autos and appliances. Many such purchases are likely financed, at least in part, on credit. Thus, it is probably the case that "home ownership" correlates with not only increased mortgage credit but also increased consumer spending and consumer credit. Since roughly 70% of the U.S. economy is based on the consumer sector<sup>17</sup>, any large-scale effort to redefine "the American Way of Life" away from home ownership should take into account any broader potential impact on the American economy.

Another fundamental observation about "home ownership", at least insofar as it means the single-family detached unit, is that it is likely the most environmentally expensive way to meet the nation's housing needs. This is true for many of the same reasons "home ownership" promotes increased consumer spending: single-family detached homes compared to say, large multi-family buildings likely promote more autos, more appliances, heavier energy usage, and so on.

*Residential housing finance product mix.* Via the process of securitization, risks can be allocated between the issuer/sponsor on the one hand and the investors on the other hand (and among different investors through tranching). But an even more fundamental risk allocation is between the consumers on the one hand and the issuer/sponsor/investors on the other hand, and examining that risk allocation through a consideration of the product mix may be a worthwhile exercise.

It is fair to say that the standard, benchmark residential product in residential housing finance is the 30-year fixed rate mortgage with limited prepayment penalties. It is also fair to say that this product is essentially a U.S. product, of limited availability in other countries, where shorter-term and adjustable rate loans are far more common.

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<sup>17</sup> "Consumer Credit in U.S. Declined More Than Forecast", *Bloomberg Business Week*, July 8, 2010, <http://www.businessweek.com/news/2010-07-08/consumer-credit-in-u-s-declined-more-than-forecast.html>

As noted above, the 30-year fixed rate product transfers interest rate and prepayment risk (refinancing risk when seen from the borrower's perspective) from the borrower to the investor. By comparison, a five-year adjustable rate loan would retain more interest-rate and refinancing risk on the borrower. Particularly if coupled with enhanced legal rules which solidify the personal liability of borrowers on their residential mortgage loans, the specter of a looming need to refinance may lead, structurally, to more conservative lending and borrowing practices in the residential mortgage finance space. The flip side of more risk retention by the borrower is less risk to the investor, whether the investor is a GSE or a private investor.

Another variable in mortgage products relates to the use of loan proceeds. In this area, the big divides are between purchase-money versus refinance or equity take out, and owner occupied versus non-owner occupied. Although all of these products are available in other jurisdictions, the primary question for the U.S. perhaps is whether products other than owner occupied, purchase – money residential housing finance transactions should benefit from any sort of government support, including eligibility for federally-provided insurance or GSE purchase. Since government mortgage insurance and entities such as Fannie Mae and Freddie Mac are by and large U.S. creations not found in other jurisdictions, these product characteristics are not directly susceptible to a cross-jurisdiction review, but are worthy of consideration by the government in terms of the federally supported residential product mix.

*Covered Bonds.* Covered bonds are the primary securitization product from abroad which is under discussion in the U.S. Several years ago, the FDIC provided regulatory guidance on the product<sup>18</sup>, and a bill has been introduced in the House to further solidify the legal underpinnings of the product<sup>19</sup>. Among knowledgeable observers, an enhanced legal regime for US covered bonds has wide support, and as a general matter the ASF supports covered bonds. Covered bonds are a popular securitization-style method of financing for housing in a number of other jurisdictions, and in Europe have been used for over a century. Covered bonds are a bank product (as distinguished from a product issued by non-depository finance companies) although this is only true as a historical matter. There is no apparent market or legal rationale which would prevent covered bonds being issued by entities other than banks (e.g., Fannie Mae, Freddie Mac or non-depository finance companies).

Although the structure is more complex, covered bonds are essentially secured debt of a bank, with the collateral being a "cover pool" of financial assets (such as mortgages). Unlike in a classical securitization, the cover pool is not a static pool, and the bonds do not amortize based upon the pool's amortization -- the structure is more like corporate debt (i.e., bullet maturities). Covered bonds, since they structurally provide for "skin in the game" (because the issuing bank is fully liable for credit risk), are a particularly attractive product for consideration in the U.S. at this time, especially in light of the much criticized "originate to distribute" practice allegedly prevalent in the residential market

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<sup>18</sup> "FDIC Policy Statement on Covered Bonds", August 4, 2008, <http://www.fdic.gov/news/news/financial/2008/fi108073.html>

<sup>19</sup> The "United States Covered Bond Act of 2010", introduced March 18, 2010, Rep. Scott Garrett of New Jersey.

during the pre-crisis years. As stated above, the ASF is generally supportive of making covered bonds available as an alternative capital markets method of financing housing (and other forms of) credit in the U.S. However, there is one principal point the ASF would like to make about covered bonds.

It is likely the case that one principal reason why covered bonds have not previously played a large role in the U.S. is because of the presence of the GSEs, which are uniquely U.S. constructs. Put another way, no jurisdiction has entities similar to Fannie Mae, Freddie Mac and the Federal Home Loan Bank System and a meaningful covered bond market. This could suggest that these may be two different ways to support mortgage finance, and how these techniques may co-exist is not something on which any other jurisdiction provides much guidance.

Consequently, ASF's only observation is that, while covered bonds appear to be a promising idea for the U.S., care should be given to the implementation of the idea in the U.S.

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We very much appreciate the opportunity to organize and/or participate in a panel discussion at the Conference on these issues of true national importance. We further understand that the Government is only at the very beginning of the process of its review, and we offer to the Government in advance continued access to the American Securitization Forum's member resources and expertise as the process of organizing the Conference continues. Should you have any questions concerning our observations, or if you feel we may further assist you in this task, please do not hesitate to contact me at 212.412.7107, [tdeutsch@americansecuritization.com](mailto:tdeutsch@americansecuritization.com), or our outside advisors on this matter, Armando Falcon of Falcon Capital Advisors, LLC at 202.393.4150, [afalcon@falconhfg.com](mailto:afalcon@falconhfg.com), or Chris DiAngelo of Dewey LeBoeuf LLP at 212.259.6718, [cdiangelo@dl.com](mailto:cdiangelo@dl.com).

Sincerely,



Tom Deutsch  
Executive Director  
American Securitization Forum