# TRANSPARENCY AS AN ALTERNATIVE TO RISK RETENTION

## HEARING

BEFORE THE

SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

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# TRANSPARENCY AS AN ALTERNATIVE TO RISK RETENTION

**WEDNESDAY, MAY 11, 2011**

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
*Washington, DC.*

The subcommittee met, pursuant to notice, at 3:22 p.m., in room 2154, Rayburn House Office Building, Hon. Patrick T. McHenry (chairman of the subcommittee) presiding.

Present: Representatives McHenry, Guinta, Amash, Quigley, Maloney and Speier.

Also present: Representatives Issa and Cummings.

Staff present: John Cuaderes, deputy staff director; Tyler Grimm and Ryan M. Hambleton, professional staff members; Peter Haller, senior counsel; Christopher Hixon, deputy chief counsel, oversight; Mark D. Marin, senior professional staff member; Rafael Maryahin, counsel; Laura L. Rush, deputy chief clerk; Becca Watkins, deputy press secretary; Peter Warren, policy director; Nadia A. Zahran, staff assistant; Sean Sullivan, intern; Jaron Bourke, minority director of administration; Jason Powell, minority senior counsel; Cecelia Thomas, minority counsel/deputy clerk; and Davida Walsh, minority counsel.

Mr. MCHENRY. The hearing will come to order. Today's hearing is entitled Transparency as an Alternative to the Federal Government's Regulation of Risk. I am Patrick McHenry, the chairman of the subcommittee. Mr. Quigley, from Illinois, is the ranking member.

Sorry for the lateness of the start of this hearing; we have just had a significant round of votes on the House floor.

As we begin all hearings in this subcommittee, I feel it is appropriate to read the Oversight and Government Reform's mission statement. We exist to secure two fundamental principles: first, Americans have a right to know that the money Washington takes from them is well spent and, second, Americans deserve an efficient, effective government that works for them.

Our duty on the Oversight and Government Reform Committee is to protect these rights. Our solemn responsibility is to hold government accountable to taxpayers, because taxpayers have a right to know what they get from their government. We will work tirelessly in partnership with citizen watchdogs to deliver the facts to the American people and bring genuine reform to the Federal bureaucracy. This is the mission of the Oversight and Government Reform Committee.

I now recognize myself for 3 minutes for an opening statement.

Today we examine the rule writing of Section 941 of the Dodd-Frank Act, which mandates Federal regulators promulgate rules requiring entities to retain a certain amount of risk on securitized assets. We will compare the rules of risk retention and its special exemptions to policies and rules that would ensure adequate transparency and standardization under Section 942 of the Dodd-Frank Act, which requires the SEC to modify Regulation AB to include loan level disclosure.

The focus of this comparison is to examine the effect that transparency and risk retention have on the market. Most importantly, how does each influence the availability and cost of credit to borrowers and small businesses?

As Federal agencies issue rules and announce comment periods, risk retention has become hotly debated. I appreciate the intention of requiring a little skin in the game, as we will say, the theory being that if an issuer retains a piece of the ongoing responsibility for the loans that they write, they have an incentive to make better loans and price them appropriately. However, like all government rules and mandates, there are exemptions provided for certain entities.

To begin with, Dodd-Frank exempts FHA from risk retention requirements. It holds this coveted advantage in the marketplace due to the full backing of the U.S. taxpayer. However, Dodd-Frank does not impose restrictions on FHA's underwriting standards, moving the agency into a position of accepting lower qualified mortgages, more or less appearing to defeat the stated intention that this administration has said, to reduce taxpayer exposure to the housing market.

In addition to exempting FHA, the QRM rulemaking does not permit private mortgage insurance to compensate for lower down payments. I have concerns about this. This raises a concern that we are driving out prudently underwritten low down payment option mortgages particularly for first-time home buyers, which I think further exacerbates the imbalance between the private market and FHA lending.

Second, Fannie Mae and Freddie Mac are exempted under the proposed risk retention rule, which runs contrary to the language laid out in the Dodd-Frank Act. And before anyone forgets Fannie and Freddie, this exemption appears to go against the administration's proposal, the broad proposal that they have to reform Fannie and Freddie and wind down the GSEs.

Third, there is no secret that risk retention favors large, well capitalized banks, as compared to smaller, less capitalized banks. Only the largest financial institutions have the balance sheet to retain, for extended periods, the 5 percent of all securitization they can plead. This leads one to ask the question, How will risk retention rules affect the operations and competitiveness of our community and small banks, and small businesses that access their loans through those institutions?

In addition, today's hearing gives us an opportunity to gage the value of risk retention in loan level disclosures and how government can push forward policies to open up our capital markets without opening the flood gates of unintended consequences. One thing is for certain: our families and businesses cannot afford overreaching government policies that increase the cost of credit and stifle economic growth. It is an imperative that our rules and regulations enable the market to appropriately price the cost of capital to our families and small businesses, while recognizing the importance of private capital in the housing sector.

I look forward to our panel's testimony.

With that, I recognize Mr. Quigley for 4 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman.

Our priority in the final analysis must be to ensure that the reforms are implemented that would prevent a repeat of the 2008 financial crisis. That crisis sparked the worst economic downturn since the Great Depression. There can be no financial crisis amnesia when it comes to implementing Dodd-Frank.

One of the chief causes of the meltdown was the originate-to-distribute model of mortgage lending. Through this model, securitization was used as a means for financial institutions to escape all of the risk associated with the mortgage loans they underwrote.

On October 23, 2008, former Federal Reserve Chairman Alan Greenspan explained in testimony before this committee, "Too many securitizers and lenders believed they were able to create and sell mortgage-backed securities so quickly that they never put their shareholders' capital at risk and, hence, did not have the incentive to evaluate the credit quality of what they were selling."

These practices led to riskier loans and misaligned incentives between lenders, securitizers, and investors in mortgage-backed securities. This originate-to-distribute model has ultimately been cited as a key driver of the current foreclosure epidemic. That is why a vital piece of Dodd-Frank Wall Street Reform and Consumer Protection Act is its provision on risk retention, Section 941. By requiring securitizers to have "skin in the game," we make lenders and investment banks more accountable for the loans they have made and facilitated.

The title of this hearing suggests that we should view transparency as an alternative to risk retention. I think there is a likely wide consensus on both sides of the aisle that increased transparency is a laudable goal. However, I would emphasize that increased transparency must not come at the expense of accountability. The proposed risk retention rule, which so many agencies worked to generate, puts a measure of accountability into effect.

As the Dodd-Frank Act's risk retention provisions are implemented, we must ensure that creditworthy families are able to access affordable loans. We must also ensure that the Nation's 5,000-plus community banks are not disadvantaged in their ability to serve their customers.

I look forward to the testimony of our witnesses on these issues and thank them for being here today.

Mr. MCHENRY. I thank the ranking member for his opening statement.

With that, let me introduce the panel, and then we will swear you in.

We have Mr. Edward DeMarco, the Acting Director of the Federal Housing Finance Agency; we have Dr. Anthony Sanders, professor of finance in the School of Management at George Mason University; we have Mr. Joshua Rosner, a partner at Graham Fisher & Co.; and we have Ms. Janneke Ratcliffe, the executive director of the Center for Community Capital at University of North Carolina at Chapel Hill.

With that, it is standard procedure of this committee to swear in all the witnesses, so if you would please stand and raise your right hands.

[Witnesses sworn.]

Mr. MCHENRY. Let the record show that all witnesses answered in the affirmative.

With that, as most of you are familiar, we have this lighting system here in Congress: green, red, and yellow. Look, we are Members of Congress; we need very basic things. So I will recognize you for 5 minutes, and with 30 seconds remaining you will get the yellow light, which means simply wrap up, and red means stop.

So, with that, Mr. DeMarco, you are recognized for 5 minutes to give an opening statement.

**STATEMENTS OF EDWARD DEMARCO, ACTING DIRECTOR, FEDERAL HOUSING FINANCE AGENCY; ANTHONY B. SANDERS, DISTINGUISHED PROFESSOR OF REAL ESTATE FINANCE, SCHOOL OF MANAGEMENT, GEORGE MASON UNIVERSITY; JOSHUA ROSNER, MANAGER DIRECTOR, GRAHAM FISHER & CO. INC.; AND JANNEKE RATCLIFFE, EXECUTIVE DIRECTOR, CENTER FOR COMMUNITY CAPITAL, UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL**

## STATEMENT OF EDWARD DEMARCO

Mr. DEMARCO. Very good. Thank you, Mr. Chairman.

Chairman McHenry, Ranking Member Quigley, members of the subcommittee, thank you for this opportunity to testify. The Federal Housing Finance Agency believes that enhancing the quality and quantity of data available to investors in mortgage-backed securities is an important step to encourage the return of private capital to the mortgage market.

To do so, we need to ensure that those owners with capital have the data needed to estimate and price mortgage credit and prepayment risk. Such transparency is a critical component of a healthy and efficient secondary mortgage market, whether or not issuers retain financial liability for some portion of the credit risk of the assets they securitize.

Risk retention, meanwhile, is a complementary measure designed to give securitizers an economic stake in the credit performance of the loans, just like investors. Risk retention seeks to protect investors and reduce information asymmetries by requiring that issuers of asset-backed securities have a financial stake in the performance of loans underlying a security, or, as it has been said, skin in the game.

Through risk retention, securitizers will have a disincentive to acquire poor quality loans for securitization because they will be required to actually hold a portion of the credit risk rather than passing it all on to investors. This exposure to credit risk should, in turn, make securitizers more careful with the quality of loan originations.

As a result of these improved incentive alignments, investors are expected to be more willing to provide capital for residential mortgages and other types of loans. This may be an important step in facilitating the return of private capital to the residential housing market and other lending markets that benefit from securitization.

Regulators published the proposed rule to implement the risk retention requirements of the Dodd-Frank Act in March. In developing that proposal, the agencies sought to implement the provision as legislated, allowing for a range of securitization structures. The public comment period on the rule extends until June 10th and the agencies invited comments on more than 100 different questions.

The MBS disclosures of Fannie Mae and Freddie Mac have expanded over the years to offer more detailed information to investors. Both enterprises provide aggregate pool level information that in many respects aligns with the Securities and Exchange Commission's Regulation AB requirements. In addition, Freddie Mac provides some amount of loan level information, and both enterprises in the past year have enhanced their disclosures on mortgage delinquencies.

Enhancing loan level disclosures on Enterprise MBS both at the time of origination and throughout a security's life is on our agenda. I believe that improving Enterprise MBS disclosures over time will help establish consistency and quality of such data. Moreover, it will contribute to an environment in which private capital has the information needed to efficiently measure and price mortgage credit risk, thereby facilitating the shifting of this risk away from the government and back into the private sector. This will take time to accomplish, but this is the direction in which we at FHFA are heading.

In sum, FHFA views risk retention and enhancing disclosure of the mortgages backing MBS as complementary reforms. We also see value in moving the enterprises over time toward the loan level disclosures that the amendments to Regulation AB proposed by the SEC would require.

Enhancements of Enterprise MBS disclosures have continued to occur since they were placed in conservatorship in 2008, and FHFA will continue down that path. We will also work closely with the other agencies to review the public comments on the interagency risk retention rulemaking before releasing a final rule that is consistent with the statutory framework. I believe that we are making progress on many fronts as Congress is beginning to take up housing finance reform.

Thank you for this opportunity, and I would be pleased to answer questions.

[The prepared statement of Mr. DeMarco follows:]

**Statement of**

**Edward J. DeMarco, Acting Director**
**Federal Housing Finance Agency**

**Before the U.S. House of Representatives**
**Committee on Oversight and Government Reform**
**Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs**

**"Transparency as an Alternative to Risk Retention"**

**May 11, 2011**

**Embargoed until delivery, 2PM EDT**

**Edward J. DeMarco, Acting Director**
**Federal Housing Finance Agency**
**Before the U.S. House of Representatives**
**Committee on Oversight and Government Reform**
**Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs**
**"Transparency as an Alternative to Risk Retention"**
**May 11, 2011**

Chairman McHenry, Ranking Member Quigley and members of the Subcommittee, thank you for the opportunity to testify. The Federal Housing Finance Agency (FHFA) believes that enhancing the quality and quantity of data available to investors in mortgage-backed securities is an important step to encourage the return of private capital to the mortgage market. To do so, we need to ensure that those owners with capital have the data needed to estimate and price mortgage credit and prepayment risk. In short, transparency is a critical component of a healthy and the efficient secondary mortgage market, whether or not issuers retain financial liability for some portion of the credit risk of assets they securitize. In today's testimony, I will address the importance of transparency in the market, the proposed risk retention rule, and proposed amendments to Regulation AB. Finally, I will describe the actions FHFA has taken and plans to take to enhance disclosures by Fannie Mae and Freddie Mac.

**Background**

The issuance of mortgage-backed securities (MBS) by fully private firms slowed dramatically at the beginning of the financial crisis. Since then, almost all mortgage securitization in the U.S. has been done by Fannie Mae and Freddie Mac, which have operated with government support since being placed into conservatorship in September 2008, and, for federally-insured and -guaranteed loans, the Government National Mortgage Association (Ginnie Mae). Only two very small private-label securitizations of single-family loans have been done in the last 13 months. In order to reduce the housing finance system's dependence on the federal government, it will be necessary to reduce the uncertainties faced by investors in private-label MBS so as to foster the confidence needed to reestablish that market. A significant contributor to the financial crisis was the poor quality of single-family mortgages originated from 2005 to 2008 and securitized by private-label issuers and by the Enterprises. It appears that often mortgage originators, securitizers, and investors were looking to the growing value of the underlying collateral—the house—rather than the creditworthiness of the borrower or the borrower's capacity to repay.

For private capital to return to mortgage securitization, investors exposed to mortgage credit risk will want greater information on the credit characteristics of the mortgages in the underlying pool and will want greater assurance of the quality of loan originations. At the time of the crisis, investors typically had access only to aggregated pool-level data on the assets backing each issue, instead of the detailed loan-level data that is necessary for independent and accurate assessment of risk.

FHFA views enhanced, loan-level disclosures as necessary for investors to analyze and assess the potential risks associated with the collateral of asset-backed (ABS) securities, including mortgages. Risk retention, meanwhile, is a complementary measure designed to give securitizers an economic stake in the credit performance of the loans, just like investors.

**Risk Retention Under the Dodd-Frank Act**

Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act was one congressional response to the housing finance debacle and to broader concerns regarding asset-backed securitization. This section requires the federal banking agencies and the Securities and Exchange Commission (SEC) jointly to prescribe regulations to require that securitizers retain a portion of the credit risk of loans that collateralize ABS. The Act included the FHFA and the Department of Housing and Urban Development (HUD) among the joint rulemaking agencies for the purpose of residential mortgage assets and also for jointly defining and creating an exemption from the risk retention requirements for qualified residential mortgages (QRM).

Risk retention seeks to protect investors and reduce information asymmetries by requiring that issuers of ABS have a financial stake in the performance of loans underlying a security, or "skin-in-the-game." Through risk retention, securitizers will have a disincentive to acquire poor quality loans for securitization because they will be required to actually hold a portion (typically at least 5 percent) of the credit risk rather than passing it all on to investors. This exposure to credit risk should, in turn, make securitizers more careful with the quality of loan originations. As a result of these improved incentive alignments, investors are expected to be more willing to provide capital for residential mortgages and other types of loans. This may be an important step in facilitating the return of private capital to the residential housing market and other lending markets that benefit from securitization.

Regulators published the proposed rule to implement the risk retention requirements of the Dodd-Frank Act in March. In developing that proposal, the agencies sought to implement the provision as legislated, allowing for a range of securitization structures. The public comment period on the proposed rule extends until June 10, 2011, and the agencies invited comments on more than one hundred different questions pertaining to the proposed rule.

**Proposed Amendments to Regulation AB**

In 2005, the Securities and Exchange Commission introduced Regulation AB to codify the requirements for the registration, disclosure, and reporting for all publicly registered ABS, including mortgage securities. The objective of the SEC's recent proposed amendments to Regulation AB is to provide investors and other market participants with additional data and tools that will allow them to understand more fully the risks posed by ABS, reduce undue reliance on credit ratings, and help restore investor confidence in the representations and warranties regarding securitized assets. The new disclosure requirements would provide more information to potential investors about the pool of assets underlying the securities, give potential investors more time to make investment decisions, and better protect the investors' interests.

Some of the major proposed changes in Regulation AB would:

- Require an issuer to provide standardized information about the loans in a pool in computer-readable form. The disclosure would require specific data related to the terms of the assets, obligor characteristics, and underwriting of the asset. Issuers would be required to provide asset-level (or, for credit cards, account-group) data at the time of securitization, when new assets are added to the pool underlying the securities, and on an ongoing basis.

- Require an issuer to file a computer program that would be accessible on the SEC's web site that investors could use to analyze information about the loans in a pool of assets.

- Provide investors more time to consider the information before making an investment decision. Under the proposed rule, issuers would be required to file a preliminary prospectus at least five business days before the first sale in the offering to give investors time to consider transaction-specific information. Currently, issuers may sell ABS almost immediately without providing investors with time to review the offering materials.

- Repeal the current condition that an issuer must receive an investment grade rating in order to be eligible for shelf registration of an ABS offering.

**MBS Disclosures of Fannie Mae and Freddie Mac**

Mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac are exempt from the disclosure requirements of Regulation AB. However, in an effort to give investors a transparent view of the assets underlying their securities, the Enterprises have attempted to ensure that their MBS disclosures parallel those required by the SEC in certain areas. Neither Enterprise currently discloses all of the information now required by Regulation AB.

The MBS disclosures of Fannie Mae and Freddie Mac have expanded over the years to offer more detailed information to investors. One notable change occurred following issuance of a 2003 report, "Enhancing Disclosure in the Mortgage-Backed Securities Markets," prepared jointly by staff of the Office of Federal Housing Enterprise Oversight (OFHEO), a predecessor agency to FHFA, the Treasury Department, and the SEC. After the release of that report, Freddie Mac and then Fannie Mae initiated pool-level disclosures for their MBS backed by single-family fixed- and adjustable-rate mortgages (ARMs). Those disclosures included pool-level data related to original loan-to-value (LTV) ratio, loan purpose, servicer identity, borrower credit score, property type (number of units), and occupancy type.

A second major development occurred in 2005, when Freddie Mac began providing more granular, loan-level information on its MBS backed by single-family mortgages. For all securities issued after December 1, 2005 and backed by fixed- and adjustable-rate mortgages, loan-level information is disclosed at the time a security is issued and on a monthly basis thereafter. Those disclosures supplement Freddie Mac's pool-level disclosures for all single-family MBS.

As mentioned above, although Regulation AB does not currently require ABS issuers to file loan-level information, the proposed revisions to Regulation AB would do so. In fact, the proposed loan-level Regulation AB disclosures would go beyond Freddie Mac's current disclosures. For example, Freddie Mac's disclosures address how loans amortize, but the proposed loan-level disclosures would require additional information. Similarly, Freddie Mac discloses information that provides an indication of the borrower's ability to pay, but the data is less detailed than that proposed by the SEC. The proposed regulation would also require reporting on loans that are modified, whereas Freddie Mac currently provides limited information on such loans.

More recently, both Enterprises began disclosing information on delinquent single-family mortgages in their MBS pools. In 2010, Fannie Mae began providing monthly information regarding delinquent loans backing its MBS. The data is provided not at the pool or loan level but in the form of aggregate statistics for groups of MBS that share the same pass-through rate, loan product type, and year of issuance. In January 2011, Freddie Mac began providing pool-level delinquency data on a monthly basis for all of its single-family MBS and Giant MBS. The proposed amendments to Regulation AB would require issuers to make loan-level disclosures of the current delinquency status of securitized assets.

**Preparing for Housing Finance Reform**

While we await Congressional action on housing finance reform, including resolution of the Enterprise conservatorships, FHFA and the Enterprises are taking concrete actions now that will enhance the mortgage market's operation regardless of the particular legislative course taken.

Briefly, we have several initiatives underway, some of which I will mention here. First, last year we announced that FHFA had directed the Enterprises to develop uniform standards for data reporting on mortgage loans and appraisals. This Uniform Mortgage Data Program is designed to improve the consistency, quality, and uniformity of data that are collected at the front end of the mortgage process. By identifying potential defects at the front end of the mortgage process, the Enterprises will improve the quality of mortgage purchases, which should reduce repurchase risk for originators. The initiative will be phased in over the course of this year and next.

Developing standard terms, definitions, and industry standard data reporting protocols will decrease costs for originators and appraisers. It will also allow new entrants to utilize such industry standards rather than having to develop proprietary systems to compete with other proprietary data systems already in the market. What Fannie Mae, Freddie Mac, or any future secondary market firm does with the data, of course, will be where market participants compete. Proprietary reviews of appraisal and loan information will depend on each firm's own unique business models and policies. But common data definitions, electronic data capture, and standardized data protocols will improve efficiency, lower costs and enhance risk monitoring.

More recently, FHFA announced the Joint Servicing Compensation Initiative. On January 18th, FHFA directed Fannie Mae and Freddie Mac, in coordination with FHFA and HUD, to consider alternatives for future mortgage servicing compensation for their single-family mortgage loans. The goals of the joint initiative are to improve service for borrowers, reduce financial risk to servicers, and provide flexibility for guarantors to better manage non-performing loans, while promoting continued liquidity in the To Be Announced (TBA) mortgage securities market.

Two weeks ago we announced that we had directed the Enterprises to align their guidelines for servicing delinquent mortgages. The updated framework will streamline and expedite borrower outreach, align mortgage modification terms and requirements, and establish a consistent schedule of performance-based incentive payments and penalties.

Following these initiatives, enhancing loan-level disclosures on Enterprise MBS, both at the time of origination and throughout a security's life, is on our agenda. I believe that improving Enterprise MBS disclosures over time will help establish consistency and quality of such data. Moreover, it will contribute to an environment in which private capital has the information needed to efficiently measure and price mortgage credit risk, thereby facilitating the shifting of this risk away from the government and back into the private sector. This will take time to accomplish, but this is the direction in which we are heading.

## Closing

FHFA views risk retention and enhancing disclosure of the mortgages backing MBS as complementary reforms. We also see value in moving the Enterprises over time toward the loan-level disclosures that the amendments to Regulation AB proposed by the SEC would require. Although MBS issued by Fannie Mae and Freddie Mac are supported by the Treasury Preferred Stock Purchase Agreements, and much of their trading is in the "To-Be-Announced" (TBA) market, the Enterprises should incorporate market best practices and provide greater transparency to investors.

Enhancements of Enterprise MBS disclosures have continued to occur since they were placed in conservatorship in 2008, and FHFA will continue down that path. We will also work closely with the other agencies to review the public comments on the interagency risk retention rulemaking before releasing a final rule that is consistent with the statutory framework. I believe that we are making progress on many fronts, as Congress is beginning to take up housing finance reform. Thank you for the opportunity to testify, and I would be pleased to answer your questions.

Mr. MCHENRY. Thank you.
Dr. Sanders.

**STATEMENT OF ANTHONY B. SANDERS**

Mr. SANDERS. Chairman McHenry, Ranking Member Quigley, and distinguished members of the subcommittee, thank you for inviting me to testify today.

Dodd-Frank requires that securitizers retain at least 5 percent of the risk in all loans that do not qualify as a qualified residential mortgage and are sold in the securitization market. In theory, 5 percent risk retention would lead securitizers to be more careful in the loan origination underwriting process.

To be sure, 5 percent retention would be the simplest approach to implement to encourage approved loan origination underwriting but, unfortunately, risk retention appears to be the least useful approach. There are four points that I would like to make.

First, the house price collapse that resulted in house price declines that far exceed 5 percent, for example, Las Vegas fell 56 percent from peak to trough. Five percent would have been blown through very quickly.

Second, risk retention does not directly address origination risk. Representations and warrants that are found in mortgage loan purchase agreements and related documents directly address origination risk. The avalanche of loan repurchase requests in the aftermath of the housing collapse makes reps and warnings less viable for non-agency-backed securities.

Third, the FHA, Fannie Mae, and Freddie Mac are exempt from the risk retention rules. Exempting these players from the mortgage market defeats the spirit of the risk retention since the loan originator would be tempted to sell or be insured by Fannie, Freddie and the FHA, rather than keep the retained risk.

Fourth, given Reg. AB, Dodd-Frank 942, and the anticipated transparency of the ABS markets, the retention rule implies that qualified institutional investors are not sophisticated enough to understand origination risks and need to be protected beyond greater transparency. Fannie, Freddie, and others do not require additional security of 5 percent risk retention since they perform substantial due diligence and analysis before purchasing securities. And also securitizers can hedge the risks of risk retention and typically, in industry experience, they oftentimes keep the piece 5 percent risk retention anyway.

In summary, it is unclear how risk retention will be implemented, vertical versus horizontal versus L cuts, and even if it is effective in reducing origination risk.

There are more effective alternatives to risk retention: transparency and improved representations and warranties.

One solution to origination risk is to provide greater transparency to investors. Transparency would permit more accurate pricing. Greater transparency potentially reduces the asymmetric information between securitizers and investors.

There has already been a movement in the industry toward this. Prospectuses and prospectus supplements promote both agency and non-agency MBS, provide detailed breakdowns of underlying loans in terms of critical risk measures such as loan-to-value ratio, loan type, and credit score. Freddie Mac has taken loan transparency to a new level in 2006 by providing a file of loan level information. The non-agency market, as well as the FHA, could provide similar loan level disclosure.

I would prefer that securitizers provide transparency themselves, rather than be forced through regulation, however. Some investors may prefer having less information disclosed, which would result in higher expected yields, compared to fully disclosed loan information. Investors should retain the right to choose how much information and what they want disclosed by securitizers.

But additional loan disclosures is one prong of the approach to improving loan quality. The other is to enact a securitization certificate approach to reducing securitization risk. Even though securitizers could release great loan level information, the market would still be concerned that the information is inaccurate. There should be mechanisms to ensure that the disclosed information is actually correct.

The securitization origination certificate approach has the potential to be effective because it directly addresses origination risk and contains a fraud penalty. The certificate would travel with the loan and would verify that the loan was originated in accordance with the law and that the underwriting data was accurate and that the loan met all the required underwriting requirements.

The certificate would be backed by a guarantee from the originating firm and demonstrate that they had financial viability. The seller must provide means of demonstrating financial responsibility, either capital or insurance, for the loans to be put in a securitization. There should be a penalty for violations of reputations and warranties beyond repurchase obligations and tracking of violations of representations and warranties available to all investors.

Thank you again for the opportunity to testify. I look forward to your questions.

[The prepared statement of Mr. Sanders follows:]

MERCATUS CENTER
George Mason University

TESTIMONY

# TRANSPARENCY AS AN ALTERNATIVE TO THE FEDERAL GOVERNMENT'S REGULATION OF RISK RETENTION

MAY 11, 2011

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Anthony Sanders
Distinguished Professor of Real Estate Finance, George Mason University
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Committee on Oversight and Government Reform
Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs

Chairman McHenry, Ranking Member Quigley, and distinguished members of the Subcommittee, thank you for inviting me to testify today. I have been asked to offer opinions on the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and its impact on Securitization, particularly risk retention.

There were a host of contributing factors to the rise and subsequent collapse of housing prices that decimated households, financial institutions and investors (including pension funds). For example, it has been argued that the Federal Reserve's expansionary monetary policy supplied the means for unsustainable housing prices and unsustainable mortgage financing.[1] In Figure 1, I show the Fed's reduction and eventual slow increase of the Fed Funds rate while house prices were rising quickly. The Fed Funds rate reached a plateau at the peak of the housing bubble, but the Fed was slow to lower the Fed Funds rates as housing prices began to collapse. As long as Fed policy can contribute to forming bubbles in asset prices (and in this case, housing), no simple risk retention rule will protect investors or taxpayers.

**Securitization Provisions in the Dodd-Frank Act**

Dodd-Frank requires that securitizers retain at least five percent of the risk in all loans that do not qualify as a Qualified Residential Mortgage (QRM)[2] and are sold into the securitization market. In theory, five percent risk retention would lead securitizers to be more careful in the loan origination and underwriting process.

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[1] Lawrence H. White, "Federal Reserve Policy and the Housing Bubble," *Cato Journal* Vol. 29, No. 1, Winter 2009, http://www.cato.org/pubs/journal/cj29n1/cj29n1-2.pdf.

[2] A qualified residential mortgage (QRM) is one with an 80 percent loan-to-value ratio, full documentation, and more traditional underwriting standards. This generally includes the 30 year fixed-rate mortgage and excludes exotic mortgages such as interest-only mortgages.

To be sure, five percent risk retention would be the simplest approach to implement to encourage improved loan origination and underwriting. Unfortunately, risk retention also appears to be the least useful approach.

First, the house price collapse resulted in house price declines that far exceeded five percent; for example, Las Vegas fell 56 percent from peak to trough.[3] [See Figure 1 for the collapse of housing prices]

Second, risk retention does not directly address origination risk.[4] Representations ("reps") and warrants that are found in Mortgage Loan Purchase Agreements (MLPAs) and related documents directly address origination risk. The avalanche of loan repurchase requests in the aftermath of the housing collapse makes reps and warranties less viable for non-agency mortgage-backed securities.

Third, the Federal Housing Administration (FHA), Fannie Mae and Freddie Mac are exempt from risk retention rules. Exempting these players in the mortgage market defeats the spirit of risk retention since a loan originator will be tempted to sell to or be insured by Fannie Mae, Freddie Mac and the FHA rather than keep the retained risk.

Fourth, given Reg AB (Dodd-Frank 942) and the anticipated transparency of the ABS markets, the retention rule implies that Qualified Institutional Buyers (QIBs) are not sophisticated enough to understand origination risks and need to be protected beyond greater transparency. QIBs (or "sophisticated investors") such as Fannie Mae, Freddie Mac, PIMCO and others do not require the additional security of five percent risk retention since they perform substantial due diligence and analysis before purchasing securities.

In summary, it is unclear how risk retention will be implemented (e.g., vertical versus horizontal versus "L" cuts) and if it is even effective in reducing origination risk.

There are more effective alternatives to risk retention: transparency and improved representations and warranties.

**Greater Transparency**

One solution to origination risk is to provide greater transparency to investors.[4] Greater transparency would permit more accurate pricing. Greater transparency potentially reduces the asymmetric information between securitizers and investors.

There has already been a movement in the industry towards greater transparency. Prospectuses and Prospectus Supplements for both agency and non-agency mortgage-

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[3] Free exchange, "Recovery comes to Las Vegas." *The Economist*, January 26, 2010. http://www.economist.com/blogs/freeexchange/2010/01/recovery_comes_to_las_vegas

4 Origination risk refers to the risk of breaches of underwriting standards, misrepresentations, fraud, poor data quality and other legal breaches

backed securities provide detailed breakdowns of the underlying loans in terms of critical risk measures such as loan-to-value ratio, loan type, credit score, etc. Freddie Mac in 2006 took loan transparency to a new level by providing a file of loan level information.[5] The non-agency market (as well as the FHA) could provide similar loan level disclosure.

I would prefer that the Securitizers provide transparency themselves rather than be forced through regulation. Some investors may prefer having less information disclosed which should result in a higher expected yield compared to fully-disclosed loan information. Investors should retain the right to choose how much information that they want disclosed by Securitizers.

But additional loan disclosure is just one prong to providing a better alternative to retained risk. The other is to enact an "origination certificate" approach to reducing securitization risk.

**Origination Certificate**

Even though Securitizers could release great loan-level information, the market would still be concerned that the information is inaccurate. There should be mechanisms to insure that the disclosed information is actually correct. Andrew Davidson and I proposed a "securitization certificate" in our paper "Securitization after the Fall."[6] In the paper, we write:

> *We propose 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 would also serve to protect borrowers from fraudulent origination practices.*

The securitization or origination certificate approach has the potential to be effective because it directly addresses origination risk and contains a fraud penalty.[7] The origination certificate would travel with the loan and would verify that the loan was originated in accordance with law, that the underwriting data was accurate, and that the loan met all required underwriting requirements. This certificate would be backed by a guarantee from the originating firm or other financially responsible firm and would travel with the loan over its life. The seller must provide a means of demonstrating financial responsibility,

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[5] See data reports provided by Freddie Mac and available at. http://www.freddiemac.com/mbs/html/data_files_5bd.html

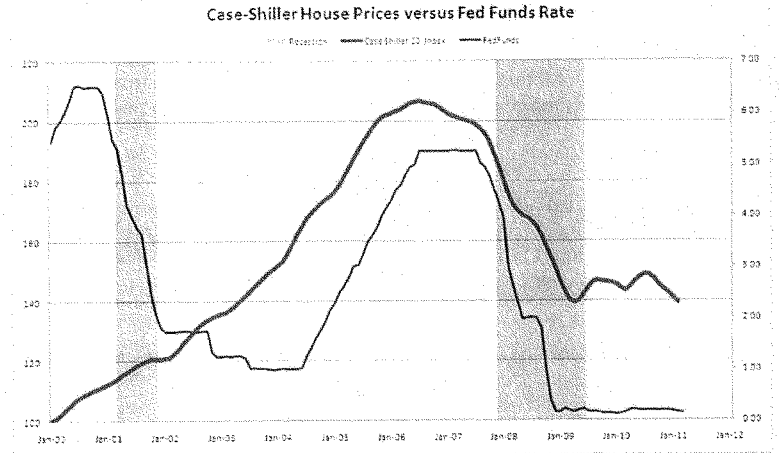
[6] Andrew Davidson and Anthony B. Sanders, "Securitization after the fall." Second Annual UCI Mid-Winter Symposium on Urban Research, "Housing after the Fall: Reassessing the Future of the American Dream." February 2009, http://merage.uci.edu/ResearchAndCenters/CRE/Resources/Documents/Davidson-Sanders.pdf.

[7] Andrew Davidson and Eknath Belbase, "Origination Risk in the Mortgage Securitization Process: An Analysis of Alternate Policies." *The Pipeline*, Andrew Davidson & Co., 2010

either via capital or insurance, for the loans to be put into a securitization. There should be a penalty for violations of reps and warrants beyond repurchase obligations and tracking of violations of reps and warrants available to all investors.

Thank you again for the opportunity to testify. I look forward to your questions.

Figure 1. Case-Shiller House Prices and Fed Funds Rate



Mr. MCHENRY. Thank you, Dr. Sanders.
Mr. Rosner.

## STATEMENT OF JOSHUA ROSNER

Mr. ROSNER. Thank you, Chairman McHenry, Ranking Member Quigley, and members of the subcommittee, for inviting me to testify on this important issue.

Current problems in the economy stemming from opacity and information asymmetry of the asset-backed market are not addressed by the Dodd-Frank risk retention rule. While the rule is well intentioned, it is also misguided. Dodd-Frank reasons that if lenders and issuers retain some financial liability for the underlying loans they sell, they will have a greater incentive to make better loans and securities.

On the surface this appears to make sense. If a lender or securitizer knows he will have to drink some of the poison he offers to others, then he would think twice about creating the potion. But as we saw in the past crisis, the banks in direst need for direct government support found themselves in that predicament precisely because they had swallowed large portions of the poison they had sold to others. Bear Stearns and Merrill Lynch didn't even have operational controls, available information, or an ability to fully model their exposures.

As we have seen, even with a 5 percent risk retention of each structure, different structures of similar underlying collateral remain highly correlated. Thus, if securitization returns and grows, risk retention will create a future systemic risk of already too big to fail firms transferring those risks to the taxpayer.

A better solution is to create industry standards of useful and timely disclosures of loan level collateral information so parties to securitization could analyze the assets' underlying pools. Even after the disaster, information asymmetry between buyer and seller remains the standards. I advocate reconsideration of the risk retention rule, but doing so without first addressing the dangerous opacity that remain in the market would only increase risks. This is especially so given that legislators have already reduced information available to investors through elimination of the Reg. FD exemption for rating agencies.

Currently, with no pre-issuance road show period during which investors have the ability to analyze a deal and its underlying collateral, the primary market for securitizations is different from the equity markets. Deals usually came to market before a collateral pool was even complete, forcing investors to rely on rating agencies' pre-issuance circulars. These tools have proven laughably inadequate.

Instead, data on specific underlying collateral in each pool should be made available for a reasonable period before a deal is sold and brought to market. Such a requirement would enhance investor due diligence, foster the development of independent analytical data providers, and reduce reliance on rating agencies. Capital and markets would be less volatile if investors could fully model the expected performance of underlying loan level collateral and regularly reassess their deviance from expectations.

Uniformity in contract is also required. PSAs and reps and warrants define features like rights to put back loans with underwriting flaws, responsibility of servicers and trustees, and the relationship between different tranches. They can be several hundred pages long. Key terms defining contractual obligations can differ significantly, and they are not standardized across the industry, across securities with the same type of collateral, or even by issuer.

It was not until the crisis that investors considered this lack of standardization. Thus, when panic set in and investors began to question the value of their securities, they knew that they didn't have time to read all the different several hundred page deal agreements, reinforcing the run on the market which caused securities values to fall further than fundamentals justified.

Legislation should create both servicing standards and a single standardized PSA governing each collateral asset class with investor and public interest at core. Standards must also focus on addressing a lack of clear definitions in securitization markets. Without a common language, the value of data is diminished. Conversely, if everyone is using the same common language, then it becomes very hard to game the system.

Amazingly, 3 years after the crisis, there is still no single standard accounting or legal definition of either delinquency or default. Currently, delinquency can be determined either on a contractual or recency of payment basis. Even among firms that would define it identically, each servicing agreement can have different interpretations of delinquency reporting. Some may report advances that a servicer makes to a pool, which could be applied to reduced stated delinquencies; others servicers may not. The wild west mentality in securitization needs to be replaced with transparency and an agreement on terms and standards.

Thank you.

[The prepared statement of Mr. Rosner follows:]

**Testimony of Joshua Rosner before the House of Representatives' Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs.**

**Hearing: "Transparency as an Alternative to Risk Retention".**

**May 11, 2011**

Thank Chairman McHenry, Ranking Member Quigley and members of the Subcommittee for inviting me to testify on this important issue.

Between 1989 and today, securitization markets, and therefore the capital markets, replaced banks as the lead funding source for home mortgages. The current problems in the real economy, stemming from the opacity and information asymmetry of the asset backed securities (ABS) market[i], are not isolated to private first-lien residential mortgage securitization markets. They extend to other areas of consumer financing like home equity loans, auto loans and other Asset Backed Securities.

The Risk Retention Rules required by Dodd Frank are well intentioned but misguided. Rather than repairing the pre-crisis "Wild West" environment, where rules are more often opaque than clear, regulators and legislators have wrongly chosen to require issuers to hold a slice of every deal they issue. They reason that if issuers retain some ongoing responsibility and financial liability for the underlying loans they sell, lenders and underwriters will have a greater incentive to make better loans or at least make sure that the cost of those loans to borrowers will be priced relative to the risks market participants identify as inherent in the loans.

On the surface, this appears to make sense. If a lender or securitizer knows he will have to drink the poison in the chalice he offers to others, then he would be more careful. If, however, because of his belief in his modeling prowess, his own systemic importance, or his financial strength, the pourer believes that he has an enhanced immunity to poison or that he will be first to receive an antidote, then perhaps he may ignore the disincentives to poison others. More likely, as we saw in the past crisis, the same firms that poisoned their investing customers failed to recognize the power of the poison. After all, the banks that were in most dire need for direct government support were so precisely because they had ingested large quantities of the poison they had sold to others. Often, as we witnessed with Bear Stearns and Merrill Lynch, these firms didn't have the operational controls, available information or resulting ability to fully model their exposures[ii]. To force them to increase concentrations of these held securities will only increase their risks.

As we have seen, even with a relatively small but required 5% retention of each structure, different structures of similar underlying collateral remain highly correlated. Thus, if securitization returns and grows, this part of the Dodd-Frank Act will have the effect of creating a future systemic risk by causing risks retained by already "Too Big to Fail" firms to be transferred to taxpayers, thus aiding the creation of another crisis of several systemically important firms becoming troubled at the same time.

A Better Solution

Nothing has been done to create industry standards or useful and timely disclosures of loan level collateral characteristics. Asymmetry of information between buyer and seller remains the standard. While I advocate repealing the risk retention rule, I would point out that doing so without first addressing these fundamental problems would be unacceptable and increase risk, especially in an environment where legislators and regulators have already reduced to information available to investors through elimination of the Regulation Fair Disclosure exemption for rating agencies[iii].

The primary market for securitizations is different from the equity markets. There is no "red herring" or pre-issuance road-show period during which investors have the ability to really analyze a deal and its underlying collateral. Typically, deals come to market so quickly that investors were forced to rely on rating agency pre-issuance circulars, term-sheets or weighted average collateral data. These tools have proven inadequate[iv]. Moreover, with a lack of pre-issuance collateral disclosure standards deals usually came to market before the collateral pool was even complete.

The Need for Disclosure

To ensure adequate transparency, data on the specific underlying collateral in each pool should be made available for a reasonable period (not less than two-weeks) before a deal is sold and brought to market. Such a requirement would enhance investor due diligence, foster the development of independent analytical data providers, and to reduce reliance on rating agencies[v]. Such an approach would reduce reliance on ratings and support a narrowing spread between price and value in the secondary market.

The automation, standardization, and public disclosure of key collateral information before a securitization is marketed — and at least monthly thereafter, in an electronically manageable and standardized format, is a necessary ingredient to the development of the deep and broad markets necessary to fund our economy. Capital and markets would be less volatile if they could fully model the expected performance of underlying loan level collateral and regularly reassess the deviance from expectation.

Contracts that Work

"Pooling and Servicing Agreements" (PSAs) and "Representations and Warranties" can be several hundred pages long. They define features like the rights to put back loans that had underwriting flaws, the responsibilities of servicers and trustees, and the relationship between the different tranches.

We need to address the lack of uniformity in the contractual obligations between various parties to a securitization. Key terms that define contractual obligations are not standardized across the industry, across issuers of securities with the same type of collateral or even by issuer (each issuer often had several different Pooling and Servicing Agreements and Representation and Warranty Agreements).

The lack of standardization and the length of the documentation effectively created opacity, which contributed to the problems in the securitization market. When panic set in and investors began to question the value of their securities, they knew that they did not have the time to read all of the different several-hundred page deal agreements.

This reinforced the rush to liquidate positions and supported a "run on the market" that caused securities' values to fall further than fundamentals justified. After all, what investor would choose to be the last one holding a security whose terms are not easily understood?

Legislation should direct regulators to create a single standardized Pooling and Servicing Agreement governing each collateral asset class whether the issued securities are registered or "over the counter" or "bespoke". These agreements should be created with the best interests of the investing public, and clarity of contract, at their cores.

### Why Standards Matter

Legislative and regulatory standard setters must also focus on addressing a lack of clear definitions in securitization markets. Without a common language and agreement on the meanings of fundamental concepts the value of data is diminished. Conversely, if everybody is using common language – in loan origination or securitization — then it becomes very hard to game the system.

Amazingly, three years after a crisis, there is still no single standard accounting or legal definition of either delinquency or default. Currently, the term 'delinquency' can be determined either on a contractual or recency-of-payment basis. Even among firms that would define it on the same basis, each servicing agreement can have different interpretations of the reporting of delinquencies. Some may report advances that a servicer makes to a pool, which could be applied to reduce stated delinquencies, other servicers may not. Like so many of the underlying problems in the securitization market, this "Wild West" mentality needs to be replaced with agreement of terms and standards.

### True Sale

In recreating the structured market, we must also clear outstanding legal questions[vi,vii] about matters such as "true sale"[viii,ix]. Without clarifying the clear legal and accounting standards on "true sale", issuers of a securitization may retain rights to or responsibility for collateral that they thought they sold and the investor in a pool believed himself to have purchased.

### Collateral Servicing and Fiduciary Obligations

When a pool of first lien mortgages is created and sold into a trust, a servicer is chosen to service the loans, collect the mortgage payments and direct the cash flows to investors as defined by agreement. While investors in different tranches to the securitization may not always have aligned interests, in light of the significant numbers of mortgages today that have negative equity most of the remaining holders would be willing to write down the principle balance of the loan if they would result in re-performance of collateral. For example, assume a 20% reduction in the principal balance of a mortgage would result in a borrower becoming willing and able to make payments and become current again, on a sustainable basis. This 20% loss, though significant, would surely be preferable to the potential 70%-plus loss investors could experience upon default and a subsequent foreclosure.

Unfortunately, due to an ill-defined legal relationship between service and investor, along with a large and common conflict of interest between the servicer and the affiliated companies that own most of the servicers, many servicers do not prefer this "less is better than nothing" approach. The largest servicers are owned by large banks -- banks that hold the majority of second liens and home equity lines on the underwater houses[x]. Remember, the second lien is, by definition, subordinated to the first lien. So if the servicer wrote down the principal on the first lien, it would, where the mortgagee is in a significant negative equity position, completely wipe out the value of the second lien and cause the bank to experience a total loss on that loan.

Because of the lack of a fiduciary obligation to the first lien holder, servicers are often motivated to protect their affiliated firm's second lien positions, rather than the first lien holders'. And because of the way the servicing agreements are written, servicers are often able to justify their inaction by hiding behind the disparate obligations they owe to investors in different tranches. Alternatively, they are able to do so by using a "net present value test" that is based on projections of unknowable future scenarios. As a result, both investors and the troubled borrower are held hostage to servicing practices that seek to protect often under-reserved banks rather than act on their expected obligation to investors in the mortgage pool. New rules in securitization should clearly define the servicer's obligations[xi] and require a fiduciary duty to the investor in securitized pools. Perhaps, more effectively, legislation should specifically prohibit financial entities from owning servicing where the servicing results in a conflict[xii].

The hope is that the original promise of securitization, through which banks could originate quality loans and sell them to investors who would be better able to hold the risks of those assets, can be realized. This would free up bank balance sheets to make more loans in support of financial intermediation and economic expansion.

Neither real estate nor the economy itself can find a self-sustaining recovery without first restarting this important tool. Liquidity cannot efficiently find its intended target unless there are credible markets in which participants can foster financial intermediation and through which capital can be transmitted. Expanding the monetary base without an effective means of financial intermediation has resulted in little more than hoarding and a fostering of new asset bubbles as witnessed by the US Treasury market and commodity prices.

[i] Mason, Joseph R. and Rosner, Josh, How Resilient are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions? (February 13, 2007), at 30 [available at: http://ssrn.com/abstract=1027472 ](see: ***The consensus view seems to be that faced with slowing demand and shrinking profit margins, subprime lenders tried to maintain volume as the housing market was faltering in late 2005 and 2006 by making riskier loans.*** Those risks are now manifesting themselves in lower profits for issuers, resulting in bankruptcy for some and significantly higher loan loss provisioning for those that remain. RMBS defaults can be expected to result in a significant decline in CDO funding for mezzanine RMBS tranches and, ultimately, a significant decline in funding for residential mortgages. Decreased funding for residential mortgages can be expected to affect housing starts and home purchases, which affect the construction and building and home products industries and are key to economic performance. Reduced economic performance further exacerbates defaults, leading to a feedback mechanism that can produce a prolonged slump in US economic performance.)

[ii] FCIC Report at 259 [available at: http://fcic.law.stanford.edu/report ]-(see: "Former CEO O'Neal told FCIC investigators he had not known that the company was retaining the super-senior tranches of the CDOs until Lattanzio's presentation to the Finance Committee. ***He was startled, if only because he had been under the impression that Merrill's mortgage-backed-assets business had been driven by demand: he had assumed that if there were no new customers, there would be no new offerings. If customers demanded the CDOs, why would Merrill have to retain CDO tranches on the balance sheet? O'Neal said he was surprised about the retained positions but stated that the presentation, analysis, and estimation of potential losses were not sufficient to sound "alarm bells.'*** Lattanzio's report in July indicated that the retained positions had experienced only million in losses. Over the next three months, the market value of the super-senior tranches plummeted and losses ballooned; O'Neal told the FCIC: "It was a dawning awareness over the course of the summer and through September as the size of the losses were being estimated".)

[iii] http://www.sec.gov/rules/final/2010/33-9146.pdf

[iv] Rosner, Josh and Joseph R. Mason, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions (May 3, 2007), at 84 [available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027475 ](The potential for prolonged economic difficulties that also interfere with home ownership in the United States raises significant public policy concerns. Already we are witnessing restructurings and layoffs at top financial institutions. More importantly, however, is the need to provide stable funding sources for economic growth. ***The biggest obstacle that we have identified is lack of transparency. The structural changes noted in our previous draft largely went unnoticed by RMBS investors until only recently. We argue that those changes went unnoticed largely because of the existing complexity and valuation difficulties underlying today's RMBS markets.***
But policymakers and ratings agencies are still reluctant to examine some of the key frictions that have caused the present mortgage mess....
And there is still no focus on monitoring bank funding markets. The feared outcome is nothing less than a 21st century bank run, this time from CDO investors rather than depositors".) [Hereinafter Rosner and Mason May 2007].

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[v] Rosner, Joshua, Toward an Understanding: NRSRO Failings in Structured Ratings and Discreet Recommendations to Address Agency Conflicts (Winter 2009). Journal of Structured Finance, Winter 2009. Available at SSRN: http://ssrn.com/abstract=1354608

[vi] Lois R. Lupica, Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic, 9 Am. Bankruptcy Inst. L. Rev. 287, 293 (noting that asset backed securities have grown from a relatively insignificant $1 billion market in 1985).

[vii] See, e.g., Jessica L. Debruin, Recent Developments in and Legal Implications of Accounting for Securitizations, 56 N.Y.U. Ann. Surv. Am. L. 367, 382 (1999), available at: http://www1.law.nyu.edu/pubs/annualsurvey/documents/56%20N.Y.U.%20Ann.%20Surv.%20Am.%20L.%20367%20(1999).pdf ("The Tenth Circuit in particular has been highly criticized, though not yet reversed, for its decision in a case involving true-sale analysis. Faced with a sale of accounts, the court in Octagon Gas Systems, Inc. v. Rimmer applied the provisions of Article 9 of the UCC to determine that the transaction constituted a security interest rather than a true sale.").

[viii] See, e.g BMeyer, Countrywide Mortgage settles with Ohio, 7 others, Oct. 6, 2008, available at: http://www.cleveland.com/nation/index.ssf/2008/10/countrywide_mortgage_settles_w.html (Author's note: If the Company has the right to enter into a settlement, for its benefit, and make commitments of third party investors in a supposedly legally isolated Trust, then it appears this action may again open the unresolved legal question of whether a securitization could ever be legally treated as a "true sale" as opposed to a disguised financing.)

[ix] Mason & Rosner May 2007 at 33 (see: "In December 2000, LTV Steel filed for voluntary Bankruptcy protection under Chapter 11 in the US Bankruptcy Court of Northern Ohio. ***In their filing the Company asked the court to grant an emergency motion to allow them to use the collections from the securitizations and claimed that the transactions were not "true sales" but rather "disguised financings". The Court granted the Company's motion though it did not rule whether or not the securitizations were "true sales".*** Although this case could have caused the rating agencies to take the same position as the Georgia law, of ambiguity making it difficult to rate the risks to noteholders they chose not to. In fact, one of the agencies appeared to pressure attorneys to avoid commenting on the matter in legal opinions. "Standard & Poor's insisted that attorneys submitting true-sale opinions to the rating agency stop referring to LTV, noting that the court never made a final decision and that such citations inappropriately cast doubt on the opinion. Seven months later, in a delicately worded press release, S&P withdrew that prohibition—apparently because lawyers refused to ignore such an obvious legal land mine".)

[x] Data available at http://www2.fdic.gov/sdi/

[xi] "OPEN LETTER TO U.S. REGULATORS REGARDINGNATIONAL LOAN SERVICING STANDARDS", December 21, 2010 available at: http://www.scribd.com/doc/45723130/Securitization-Standards-Letter

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[xii] H.R. 4953--111th Congress: Mortgage Servicing Conflict Elimination Act of 2010." GovTrack.us (database of federal legislation). 2010. March 28, 2011 <http://www.govtrack.us/congress/bill.xpd?bill=h111-4953 >

Mr. McHENRY. Thank you, Mr. Rosner.
Ms. Ratcliffe.

**STATEMENT OF JANNEKE RATCLIFFE**

Ms. RATCLIFFE. Good afternoon, Chairman McHenry, Ranking Member Quigley, and members of the subcommittee. As mentioned, I am with the UNC Center for Community Capital. I also serve on the Mortgage Finance Working Group convened by the Center for American Progress to offer a plan for responsible housing market reform. Please note that the views expressed are my own and that focus on the mortgage market aspects of the questions raised today.

I am honored to be asked to discuss how transparency and accountability can help restore confidence in the once robust U.S. mortgage system. Confidence in that system was shattered among investors and borrowers at both ends of the system, and the taxpayers who find themselves propping it up. Only the full faith and credit of the government has kept the market open and, ultimately, private capital must bear a greater share of the load.

The crisis was a result of abuses that arose in a regulatory vacuum and a climate of inadequate transparency, lack of accountability, and misaligned interests. The Dodd-Frank Act identifies key steps toward a market that is safer for investors, taxpayers, and for borrowers. One of these is transparency. Lack of transparency in the private label market enabled adverse selection and underpricing of risk because issuers knew more than investors.

Certainly, better loan level information and product standardization will help usher back in the private market. But even with good loan level data, private market investors will face potential principal-agent problems and conflicts of interest. Nor will this help borrowers, many of whom took on loans when the true costs and consequences were masked by complexity.

The system cannot function well unless borrowers' interests in repaying their loans and investors' interests in being repaid are served by the agents in between them. So risk retention can help address these principal-agent problems by aligning incentives and holding issuers more accountable, as Dodd-Frank intends.

While the regulatory proposal largely mirrors this intent, we are concerned that a too narrow QRM box may discourage private capital participation and possibly disrupt the fragile market. For example, the down payment criteria may put a pro-cyclical damper on the fragile housing recovery, particularly if mortgage insurance is not taken into account. That would be a pity, as we have ample experience about the right way to finance lower down payment mortgages.

At UNC we study a large pool of mortgages made in the decade preceding the crisis under affordable housing and CRA programs. The borrowers had access to prime fixed rate, long-term amortizing mortgages that they could afford to repay. These households have experienced low default rates and, on average, meaningful equity buildup. We found that non-prime loans made to similar borrowers were several times more likely to have defaulted than those in our study. Key factors associated with these higher defaults were adjustable rate, broker channel, and prepayment penalty.

These findings underscore that risk retention should apply to product and process factors that increase risk, not to characteristics of borrowers. That said, overall, the risk retention provisions will certainly improve accountability and, with greater transparency, should put more natural market imposed limits on the total amount of risk taken on by the system.

But even transparency, standardization, and risk retention are not, in and of themselves, enough to return the market to long-term vibrancy and resilience, and attract the amount of private capital needed. These are just two of the tools needed to rebuild the market. The system must also provide for broad and constant liquidity for a nearly $11 trillion market, mechanisms that limit volatility, access to affordable and sustainable financing for home ownership and rental housing, including for underserved segments, and preservation of the long-term fixed rate mortgage, which provides economic stability at the household and macroeconomic levels.

All this can be achieved with private capital serving the lion's share, with the provision of a limited Federal backstop that is highly protected by adequate private capital in the first loss position, and that is explicit and that is paid for. Such a mechanism will provide investors the confidence to deliver a reliable supply of capital for both rental and home ownership options every day and in every community over economic cycles through large and small lenders, alike.

In summary, restoring confidence in the mortgage market will require greater transparency and greater accountability, though we recommend a broader QRM definition than regulators have proposed. However, the ultimate impact of these measures is highly dependent on the form that the mortgage secondary market takes.

As you move forward in this complex process, it is important to bring private capital back, it is important to protect the taxpayers, but it is also important to restore the financial system so that it works better for the American households who rely on it for economic security. Transparency and confidence throughout the system depends on having informed borrowers who have access to sound, well underwritten loans.

[The prepared statement of Ms. Ratcliffe follows:]

**Statement of Janneke Ratcliffe**
**Executive Director**
**UNC Center for Community Capital**

**Before the**
**Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs**
**United States House of Representatives**

**Hearing on**
**Transparency as an Alternative to Risk Retention**
**May 11, 2011**

Good morning Chairman McHenry, Ranking Member Quigley and members of the subcommittee. I am Janneke Ratcliffe, Executive Director for the Center for Community Capital at the University of North Carolina at Chapel Hill. I also serve on the Mortgage Finance Working Group sponsored by the Center for American Progress; a group of mortgage finance experts who have authored a plan for a responsible market for housing finance reform. Please note that the views expressed here today are my own, and further, that they focus largely on the housing finance aspects of the questions you have raised.

I am honored to have the opportunity to share some thoughts on the critical question of how transparency and accountability can help restore confidence in the once robust US mortgage system. Confidence in that system was shattered, among both the investors and the borrowers that stand at both ends of the system as well as the taxpayers who found themselves propping it up. The crisis of 2007/2008 was a result of abuses that arose in a regulatory vacuum and a climate of inadequate transparency, lack of accountability and misalignment of interests and incentives.

For the last 3 years, only the full faith and credit of the US government has kept investors in the market, while borrowers remain cautious. It is widely recognized that private capital must bear a greater share of the load going forward. The Dodd-Frank Act identifies several key steps to safety and soundness and avoiding a similar debacle in the future. These steps are necessary if we want private capital to re-enter the market and American families to resume investing in their homes, neighborhoods, communities and futures. Restoring confidence on both sides of the transaction is the first step to returning the housing market to one that is stable, affordable and largely reliant on private capital, while ensuring housing-market stability and taxpayer protection.

This is no small task. Applying lessons learned and keeping the end in sight are key -- Any such future market must be characterized by liquidity, stability, transparency and standardization, affordability, and consumer protection.

Transparency and accountability, as embodied in risk retention standards, are essential to achieving these ends. They must be balanced with each other, but also with reform of the mortgage secondary market, housing policy goals, and the interests of the broader financial market and economy. Importantly, there must be transparency and accountability to the borrower, as well as to the investor, for the system to be sound.

***The importance of transparency and standardization.***
During the housing bubble, the housing finance system experienced a seismic shift toward complex and heterogeneous products that could not be understood by consumers at one end of the chain to securities that could not be understood by investors at the other. The lack of transparency and standardization set the

stage for adverse selection because the issuers knew more than the investors. Even as the risk on private label securities increased, the yields demanded by investors declined (see Levitan and Wachter, 2010).[i] Similarly, for borrowers, complexity and opacity led many to take out loans where the consequences and risks were poorly understood.

These information failures occurred-- and need to be addressed--on several levels. First, underwriting and documentation standards must be clear and consistent across the board so consumers, investors, and insurers can accurately price risk and compare options, and regulators can hold institutions accountable for maintaining an appropriate level of capital. Second, in the pure private market, investors need loan level information, not simply pool level data, to more accurately assess the credit risk of a security. Third, as the private label market boomed, complexity at the security level served to further shroud information.

These concerns are particularly critical for investors who are exposed (either directly or indirectly) to credit risk. As Ginnie Mae, Fannie Mae and Freddie Mac take on 100% of the credit risk for their securities, investor need for transparency is much lower in the conforming and government segments. Moreover, in these sectors, investors can rely on regulations and standards to provide for a relatively homogenous and predictable risk profile, a condition which allows for the TBA market,[ii] and which also enables borrowers throughout the market to receive mortgages with well-understood terms that they can easily comparison shop. Even outside the US, successful securitization has generally been accompanied by government support, either implicit or explicit, and strict government product regulation. Secondary market transparency and standardization have the added benefit of lowering costs and increasing availability of financing.

As for the pure private market, more granular loan level information and more standardization in product structures will help enable the re-emergence of a competitive and efficient private mortgage-backed securities market. Loan level data would enable investors, insurers and ratings agencies to better evaluate the impacts of layered risks on individual loans, for example. The Project on Residential Securitization Transparency and Reporting launched in July 2008 by the American Securitization Forum calls for loan level reporting of some 160 data points on each loan[iii] as well as new standards for bond level reporting and strengthening reps and warrants.[iv] The additional transparency should be an important element in ushering a new and better mortgage market.

But not all by itself. Even with loan level data, investors will still be exposed to principal-agent problems and conflicts of interest. Originators and Issuers will still have access to greater information than investors can observe. Among the problems that will not be solved by provision of data is adverse selection – where originators/issuers may choose a different execution for loans they know to be of different risks. Potential conflicts of interest also arise with issuers who are also servicers and/or second lien holders. More blatantly, there remains the risk of misrepresentation, particularly with poor mechanisms for redress or in the case issuers are not financially able to fulfill rep and warrant obligations. These problems cannot be fully solved with data and standardization. (For a discussion of principal-agent problems see Goodman et al, 2010, pp 10 – 27.)[v]

Besides principal-agent risk, the mortgage market is prone to systemic, correlated risks and large risk tails which full information alone cannot fully correct. Detailed information does not assure that the right conclusions will be reached and the right decisions made. Weaknesses in the ratings process of the credit rating agencies[vi] and the fact that investors and insurers misapplied sophisticated financial models[vii] are well documented. For example, AIG believed "....that their risk models indicated that the underlying securities would never go into default." (Donnelly and Embrechts, p. 14).

These concerns confirm that transparency in the form of greater information is only part of the solution. Two other elements that go hand in hand with transparency are: 1) product and underwriting standards, and 2) greater accountability for agents (namely, originators and issuers). Dodd-Frank recognizes the importance of these elements in the call for risk retention, in the designation of a Qualified Residential Mortgage and in prohibiting extension of mortgages without evaluating ability to repay.

***The importance of accountability.***
Risk retention at a 5% level is aimed at addressing the principal-agent problems mentioned previously, and at better aligning the interests of borrowers and investors with the agents in between them: originators, lenders, and issuers.

The recently released regulatory proposal implementing risk retention demonstrates, however, just how complex the issue is. The proposed QRM definition excludes nearly 70% of the loans acquired by the GSEs in 2009 (generally that share is above 75%) and an even higher percentage of FHA loans, suggesting that today, the vast majority of single family mortgages originated would require risk retention, as would a similarly large share of the multifamily market. Yet the implications for this sweeping provision remain unclear. What are the implications for capital requirements? Borrowing costs? The ability of many types of lenders and securitizers to make non-QRM loans? Will non-QRM loan risk concentrate on the balance sheets of large banks with both explicit deposit insurance and an implicit TBTF guaranty? Or will it all flow to the FHA, which is 100% taxpayer backed? Today, the GSEs – Fannie Mae and Freddie Mac – meet the risk retention requirement because they "hold" 100% of the risk of their issues, and the condition of conservatorship ensures that this position is solidly backed. (Note that this is not the same as an exemption from the risk retention requirements. The GSEs are just exempt from the premium recapture account provisions and the hedging restrictions). However, what will be the treatment of successor institutions? How will the rule ultimately consider certain types of third-party guarantees that are demonstrated to add safety and soundness? What will be the preferred form of non-QRM loans – that is, will they carry layered non-QRM risk factors such as adjustable interest rates? Will regulators adapt the QRM standards as de facto safety and soundness guidelines? With all these unknowns and potential unintended consequences, it is not clear whether the proposed risk retention standards will adequately protect against conflicts of interest.

One thing is clear – there is a high probability that risk retention requirements linked to a too-narrow QRM box will discourage private capital participation and possibly disrupt the limited market that exists today, which by all determinations is some of the safest lending in recent memory,[viii] and is overwhelmingly non-QRM. As the regulation itself states: "The Agencies recognize that many prudently underwritten residential mortgage loans will not meet the proposed definition of a QRM."[ix]

Our own research confirms this point and suggests that the restrictions on LTV – which were not called for in the Dodd-Frank Act -- and likely on debt to income as well, could quite possibly and unnecessarily act as a damper on the housing market.

We have ample evidence that many households who may not fit the "20 percent down, established credit, 36 percent debt-to-income" model can become successful long-term homeowners, when given access to well-underwritten, standard, affordable, fixed-rate financing.[x] At UNC, we follow a portfolio of nearly 50,000 mortgages made by banks across the country over the decade preceding the crisis; loans made under affordable housing and CRA programs. The median borrower earned $30,792 a year, more than half of them had credit scores of 680 or below, and 69 percent put down less than 5 percent on their home purchase. The delinquency and default rate on these loans is a fraction of that of subprime mortgages. In fact, the households have on the median, and over the period, managed to build more assets than through any other available mechanisms. They were able to do so because they had access to prime, fixed-rate, long-term amortizing mortgages that they could afford to repay.

In fact, by comparing the performance of these borrowers with those of similar borrowers who received non-prime loans, we were able to isolate the risk introduced by terms and conditions of the loans rather than the borrowers. Non-prime loans made to similar borrowers were three to five times as likely to have defaulted as those in our study population. Key factors associated with the increased in risk were adjustable rate, broker channel and prepayment penalty.[xi]

These findings underscore that the principal-agent problem is best addressed by the risk-retention requirement as applied to product and process factors, not to characteristics of the borrowers. Meanwhile, the Dodd-Frank provisions requiring underwriting for ability to repay should lead agents to use common sense and proven approaches to qualify borrowers for loans.

Importantly, the borrower-based criteria of the QRM are likely to have unintended consequences. As noted, most mortgages made today are non-QRMs. It is particularly unclear why the regulators sought to impose an LTV standard when it was not called for in the Dodd-Frank Act.

Access to safe and affordable financing for low down payment home purchases is critically important because home ownership continues to be the cornerstone of household wealth in the United States. At a macro level, real estate holdings comprise the largest element of household assets in the United States.[xii] Its value to individual families is equally profound, and increases as you go down the income spectrum, with home equity comprising more than three quarters of the wealth of low-income families.[xiii] Moreover, homeownership continues to be one of the best potential answers to the persistent racial wealth gap. The median wealth of black families is a fraction of that of the median white family ($5,000 vs. $100,000, respectively as of 2007).[xiv] This gap is echoed in homeownership rates: As of the end of 2009, roughly 72 percent of white households owned their own homes, less than half of African-American and Hispanic households owned theirs. Among Hispanic and Black households, owners have 39 and 85 times the wealth of renters, respectively.[xv]

According to the National Association of Realtors® the median sales price of a single-family home in the US in 2009 was $172,100; making a 20 percent down payment required $34,420 in assets, greater than the entire annual income of roughly a third of all U.S. households.[xvi] Restrictions on the availability of higher LTV loans will raise a substantial barrier to new households starting up the ladder of homeownership, to repeat buyers hoping to move up it, and to recovery of the housing market.

***There is a right way to do high loan-to-value lending***

It is well understood that low equity is associated with higher risks; if a borrower with little home equity loses their job, for example, they cannot easily sell the house to pay off the mortgage. But even in the wake of the foreclosure crisis, we have evidence that this risk can be managed through financing that has enabled hundreds of thousands of working families with modest incomes to become successful homeowners. This was accomplished not through exotic mortgages that created only an illusion of homeownership, but through consumer-centric policies and practices that removed barriers to homeownership for first-time, minority and low-income families, responsibly. These programs did not develop out of financially engineered sleight of hand that failed to account for risk. They evolved through decades of careful innovation, such as Community Reinvestment Act lending programs, new approaches introduced by mortgage insurance companies and GSEs, adjustments to underwriting guidelines, pre-purchase counseling, and down payment assistance programs. These efforts paid off in a steady increase in homeownership rates between 1995 through their peak in 2004. Note that the subprime boom was just getting into full swing then, and that during the peak years of the housing bubble, 2004 – 2007, homeownership rates actually leveled off and started to decline through the foreclosure crisis.

It is critical for regulators to recognize this distinction: fostering responsible lending to households who, despite low wealth or low income can still participate in the benefits of homeownership, is very different from encouraging the extension of risky loans that put households in financial jeopardy and seed systemic risks.

In the mid-2000's, private-label mortgage backed securities grew to surpass Fannie Mae and Freddie Mac's market share, as the GSEs new business as a share fell from 57% in 2003 to just 37% in 2005 and 2006.[xvii] Eventually, Fannie Mae and Freddie Mac increased purchases of non-traditional loans, which generated substantial losses. For example, Alt-A loans represented just 7% of Fannie Mae mortgages from 2004 and earlier, but increased to about 20% in 2005 and 2006.

Such purchases were not driven by policy concerns. Alt-A mortgages are generally characterized as loans to borrowers with good credit but using nontraditional underwriting standards. For example, Alt-A loans often use no or limited documents of income and assets. A Federal Reserve review states that 50% to 60% of Alt-A loans generally involves low documentation, but that share increased to 78% by the end of 2006.[xviii] Loans without income documentation, particularly if used as a way to inflate income, are less likely to be claimed to be to lower income borrowers. In fact, according to the GSE's second quarter 2008 credit supplements, the average loan amount for an Alt-A loan purchased by the GSEs was above $170,000 and only a small share – 5% - of these loans had LTV above 90%. Further, the average FICO score on Alt-A mortgages was a reasonably strong 715 for Fannie Mae and 724 for Freddie Mac.

There are also reasons to believe Alt-A loans are not targeted toward underserved neighborhoods. Using the average outstanding balance and mark-to-market LTV, the average value of property behind a Fannie Mae Alt-A loan was over $250,000 in 2007, substantially greater than other "non-traditional" loan categories and over 15% greater than the median sales price for all existing single-family homes that year. These Alt-A loans led to substantial losses. In the first half of 2008 (the half preceding conservatorship), Alt-A loans accounted for nearly 11% of Fannie Mae's single-family book of business, but accounted for over between 43 and 49% of their credit losses.

Meanwhile, data from FHFA shows Fannie and Freddie purchased roughly 9.5 million loans between 2005 and 2007 that qualified for one or more affordable housing goals. Nearly 73% of these had loan-to-value ratios of 80% or less. Less than 17% had LTV ratios over 90%.[xix] Applying the reported ever 90-day delinquency rate of all GSE loans by LTV categories, the estimated default rate of loans purchased in this time period by Fannie and Freddie with this distribution of LTV ratios is barely above their overall default rate for all loans purchased over the period. Even if we conservatively apply the default rate for loans under 660 within each LTV bucket, this increases the roughly estimated default rate for these loans to a leve substantially below the comparable default rate for all loans financed by private-label securities, regardless of LTV or FICO. Further, in comparisons of rates of serious delinquency between the GSEs and the private label market in all categories of LTV and credit score for loans originated and acquired from 2001 through 2007, GSE loans outperform private label MBS loans, usually by huge margins.[xx]

Taken together with our research findings on a large portfolio of loans originated under Community Reinvestment Act and Affordable Housing programs, these results support the conclusion that the use of prime-market-rate, fixed-rate mortgages for lending to low- and moderate-income borrowers lead to lower defaults than non-traditional loans by private origination channels.

***Transparency and Accountability are just part of the solution***

Clearly, rebuilding the US financial system is no easy task, but learning from the past – both what worked well and what failed - offers the opportunity to establish a more stable system than ever before. Accountability and transparency are two critical elements, and coupled with consumer protection measures of Dodd-Frank, comprise part of the overall solution. But alone, they will not replenish the flow of capital needed to support a robust housing market over the long term and through business cycles. In fact, even as the pure private market gradually returns, a sole reliance on pure private markets will put the housing market recovery at risk in the short term. In the long-term, it will leave some markets in some economic cycles cut off from a liquid supply of mortgage credit on fair and sustainable terms and the entire economy exposed to bubble-bust cycles. To return to long-term vibrancy and resilience, the system must also provide for liquidity on a broad and constant basis; stability; and access to affordable financing for homeownership and rental.

*Broad and constant liquidity to fund the $11 trillion US mortgage market*
A substantial share of the market can be served mostly by private capital with the provision of a limited federal backstop that is highly protected by adequate private capital in the first loss position, and that is explicit and paid for. Such a mechanism will provide investors the confidence to deliver a reliable supply of capital for both rental and homeownership options, every day and in every community, during all kinds of different economic conditions, through large and small lenders alike.

*Financial stability instead of volatility*
As we have been reminded, when left to its own devices, the mortgage market is inherently inclined toward extreme bubble-bust cycles, which cause significant wealth destruction that brings with it devastating repercussions not only for homeowners and lenders but also for neighborhood stability, the financial system, and the broader economy. Mitigating that tendency requires strong, consistently enforced underwriting standards and capital requirements that are applied equally across all mortgage financing channels for the long cycle of mortgage risk, and mechanisms that assure countercyclical funding availability.

*Affordable and sustainable financing for both homeownership and rental housing*
Liquidity and stability are essential to affordability and, for most families, the lower housing costs produced by the modern mortgage finance system over the past half century (before the recent crises) enabled them to build equity, save, and invest.

A pillar of this housing system is affordably priced long-term, fixed-rate, fully self-amortizing, prepayable mortgages. The long term provides borrowers with an affordable payment while the fixed-rate, the option to prepay, and self-amortization features provide the financial stability and forced savings that are critically important to most families, while retaining the opportunity for mobility.
Multifamily rental housing also gains stability from long-term, fixed-rate financing as it results in more affordable and stable rents.

In the absence of government policies designed to explicitly support long-term, fixed-rate mortgages, it is likely that this type of mortgage would largely disappear from the U.S. housing landscape or become unaffordable to the nation's middle class, which has been so effectively served by 30-year residential mortgages, and to the nation's many renters who rely on multifamily property owners' ability to finance and refinance their apartment buildings.

Liquidity, stability and the efficiently priced long-term fixed rate mortgage contributed to the building of a strong middle class and has been an important guiding concept in modern U.S. housing finance policy—and a key component of the American socioeconomic mobility of the 20th century. It has not always been available to all qualified borrowers, however.

Broad access to such sustainable financing for all qualified homeowners and renters can be achieved in the future -- if successors to certain GSE functions are structured to be able to make non-QRM mortgages. With adequate capitalization, standardization and oversight, GSE successors should facilitate certain non-QRM mortgages in a way that protects taxpayers while adding stability to the housing market.

In conclusion, restoring investor confidence in the mortgage market will require much greater transparency than in the past. It will also require more accountability on the part of agents, as envisioned by the Dodd-Frank Act's risk-retention provisions. However, regulators should proceed with care to avoid putting an unintended and pro-cyclical damper on the fragile finance system. In particular, our research suggests that a broad QRM definition will better balance the value of risk-retention with the goal of reducing the government role in the market from current levels and protecting the taxpayer over the long run. Our research suggests that it is more appropriate to apply risk retention requirements to mortgages with features that in and of themselves increase risk, rather than to borrower characteristics. Finally, the ultimate impact of these measures is highly dependent on the form that the mortgage secondary market takes. As you move forward in this complex reform process, it is important to bring private capital back and protect the taxpayer, but it is also important restore the financial system so that it works better for the American households who rely on it for their economic security. You cannot have true transparency and valuable information at any level if, at the origination level, the risks are not understood by the borrower.

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[i] Levitan, Adam and Susan Wachter, 2010. Information Failure and the US Mortgage Crisis. University of Pennsylvania Law School Institute for Law and Economics.

[ii] The TBA or To Be Announced Market allows conforming, conventional mortgages to trade more efficiently and allows borrowers to lock rates in advance of closing. For an excellent description, please see James Vickery and Joshua Wright, 2010, TBA Trading and Liquidity in the Agency MBS Market. Federal Reserve Bank of New York Staff Report no. 468.

[iii] http://www.americansecuritization.com/uploadedFiles/ASF_Project_RESTART_Final_Release_7_15_09.pdf

[iv] See http://www.americansecuritization.com/story.aspx?id=3461.

[v] Amherst Mortgage Insight, May 20, 2010. Lori Goodman, Roger Ashworth, Brian Landy and Lidan Yang. The Elephant in the Room--Conflicts of Interest in Residential Mortgage Securitizations. Amherst Securities Group LP.

[vi] SEC (2008). Summary report of issues identified in the commission staff's examinations of select credit rating agencies. July 8 2008, United States Securities and Exchange Commission. http://www.sec.gov/news/studies/2008/craexamination070808.pdf.

[vii] Donnelly, Catherine and Paul Embrechts, 2010. The Devil is in the Tails: Actuarial Mathematics and the Subprime Mortgage Crisis. RiskLab, ETH Zurich, Switzerland.

[viii] See for example Statement of Edward J. DeMarco before the US House of Representatives Subcommittee on Capital Markets, Insurance and Government Sponsored Entities, March 31, 2011 regarding Credit Quality (p. 2) and Written Testimony of David H. Stevens, "FHA Capital Reserve Ratio," before the Subcommittee on Housing and Community Opportunity, US House Committee on Financial Services, October 8, 2009.

[ix] Interagency Notice of Proposed Rule Making on Credit Risk Retention. March 28, 2011.

[x] Abromowitz, David and Janneke Ratcliffe, April 1, 2010. Homeownership Done Right-What Experience and Research Teaches Us, Center for American Progress. Available via http://www.americanprogress.org/issues/2010/04/homeownership_right.html

[xi] Ding, Lei, Roberto Quercia, Wei Li and Janneke Ratcliffe, 2010. Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models. http://www.ccc.unc.edu/abstracts/091308_Risky.php

[xii] Board of Governors of the Federal Reserve, Balance Sheet of Households and Nonprofit Organizations (2010) available at http://www.federalreserve.gov/releases/z1/Current/z1r-5.pdf

[xiii] Di, Zhu Xiaou Housing Wealth and Household Net Wealth in the United States: A New Profile Based on the Recently Released 2001 SCF Data (Cambridge: Joint Center for Housing Studies, Harvard University, 2003).

[xiv] Thomas M. Shapiro, Tatjana Meschede, and Laura Sullivan, The Racial Wealth Gap Increases Fourfold. (Waltham: Institute on Assets and Social Policy, 2010).

[xv] Joint Center for Housing Studies, Harvard University, State of the Nation's Housing 2009; Appendix W-5 (2009).

[xvi] U.S. Census Bureau 2010 Statistical Abstract. 35.5 percent of U.S. households earned less than $35,000 (2007 dollars).

[xvii] http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0409-GSEs.pdf Figure 11
[xviii] http://research.stlouisfed.org/publications/review/10/01/Sengupta.pdf
[xix] http://www.huduser.org/portal/datasets/GSE/profiles_05-07.pdf
[xx] Calculated from FHFA available here: data http://www.fhfa.gov/Default.aspx?Page=313

Mr. MCHENRY. Thank you, Ms. Ratcliffe. Thank you for your testimony.

I appreciate the whole panel's testimony.

With that, I am going to recognize the Vice Chair, Mr. Guinta, of New Hampshire, for 5 minutes for the first round of questions.

Mr. GUINTA. Thank you, Mr. Chairman.

Thank you all for coming and testifying this afternoon.

The first question I would like to throw out to the panel. My question is simply this: Who is purchasing these mortgage-backed securities and what level of sophistication do these buyers have? Then, second, are these the types of buyers that need assurances through risk retention or is it, in your opinion, that because of their qualification they don't need assurances?

We can start with Mr. Rosner.

Mr. ROSNER. The buyers are qualified institutional buyers; they are sophisticated investors. The very nature of the structure of selling MBS is that you have to sell the equity RMBs tranch before you can sell the investment grade rated tranches, so typically the buyer who is the key buyer is the one who is going to do the most due diligence if the information is available.

Given the ability to look at loan level data before a deal comes to market, they will therefore be the determinant of price by determining what they perceive as value. I don't think they need assurances as much as they need clarity of contract and as much as they need the loan level data probably in preformatted industry standardized format to do that analysis for a period before a deal comes to market.

Mr. GUINTA. Dr. Sanders.

Mr. SANDERS. Thank you. I agree with what Josh is saying, and I would say that PIMCO, LAMCO, Fannie, Freddie, and most of these investors were talking about, the QIBs, are extremely sophisticated investors; they do their homework, due diligence. I agree with Josh that it would be nice if they could get information on loan level details ahead of time. In fact, I am surprised they haven't been requesting that over time. But if you look at it again, as I said, pro-supps and prospective supplements issued by various, they do go into fairly detailed loan level analysis, but it is not as much as like Freddie gave out on their loan levels, which is what I would like to see going forward.

Mr. GUINTA. Ms. Ratcliffe, would you agree that they need clarity of contract rather than the assurances?

Ms. RATCLIFFE. I think that they are both important. There was not as much loan level data information, and clearly having that available to the investors should help their ability to assess the risk, there is no question of that. I still think that doesn't take care of all the principal-agent problems that might arise. There could still, of course, be misrepresentation; there could still be adverse selection. And even with full data, a lot of the complicated models were used; people were not necessarily coming up with the right answers. So I think there are a lot of different risks inherent in the system, and each of these solutions we propose addresses a different set of issues, so I am not sure it is an either/or.

Mr. GUINTA. Mr. DeMarco.

Mr. DEMARCO. I would only add to what the panelists have said is that when we think about the holders or investors in mortgage-backed securities, probably important, we want to know who they are and how they are responding to these things to distinguish between those that are investing in private label mortgage-backed securities for which the credit risk is managed through the securitization structure and each of the investors, no matter where they are in that structure, understand they are undertaking credit risk; and those that are investing in Ginnie Mae mortgage-backed securities or now with Fannie and Freddie in conservatorship and operating with the backstop of the Treasury Department, the sense of government support, the credit analysis and the credit review of the investors and also what they are looking for in security is clearly going to be different for some of those investors relative to investors in private label mortgage-backed securities.

Mr. GUINTA. Ms. Ratcliffe, I want to go back to something that you mentioned. You said that only really essentially solves part of the problem relative to misrepresentations. Don't we have other laws, though, on the books now that are sufficient relative to misrepresentation?

Ms. RATCLIFFE. I think it is a matter of the processes and tools that are available, the remedies that are available to the investors. I think we had some proposals made here that would again address some of those a little better, I think.

I guess, while I have the mic, I might also add that the investors who are making these investments today in the private market, not in the Fannie-Freddie securities, they are a very small universe of investors right now who are undertaking actually extensive and lengthy due diligence. So if what you are talking about instead is a situation where private investors could return in large scale, it would probably be a very different scenario.

Mr. GUINTA. And then I only have a few seconds left, but to Mr. Rosner, can you just talk very quickly about the unintended consequences that you see in risk retention?

Mr. ROSNER. Well, again, the assumption in the risk retention rule is that the banks acted, the issuers acted maliciously in all circumstances and that forcing them to retain risk would solve for that. Quite often what we have found is that they made assumptions based on models which proved to be deeply flawed and historic assumptions that proved to be inaccurate and retained risks themselves. Forcing them to retain risks and creating a system where everyone is mismodeling the same problem, the same collateral at the same time will risk creating a situation where the correlation ends up demonstrating again to cause a systemic crisis as it did, and that would be better to have those risks dispersed in the hands of investors rather than concentrated back in our depository institutions or investment banks.

Mr. GUINTA. Thank you very much.

I yield back.

Mr. MCHENRY. I thank you.

At the request of the subcommittee ranking member, I will first yield on their side of the aisle to the full committee ranking member, Mr. Cummings.

Mr. CUMMINGS. Thank you very much, Mr. Chairman. I want to thank you all for calling this hearing.

As I listened to you, Mr. Rosner, I could not help but think about all the people who are out of their houses, the ones in my district who have lost big time; the ones who come to foreclosure conferences, and I have held six of them in the last 2 years, crying.

And it is very unfortunate how short our memories can sometimes be. It appears that some members of the committee do not recall that one of the frequently cited statements articulating the causes of the financial crisis was made in this very hearing room at the very table that you all are sitting at.

On October 23, 2008, at the height of the financial crisis, the full Committee on Oversight and Government Reform held a hearing entitled, The Financial Crisis and the Role of Federal Regulators, at which former Federal Reserve Chairman Dr. Alan Greenspan, testified, "What went wrong with global economic policies that had worked so effectively for nearly four decades, too many securitizers and lenders believed they were able to create and sell mortgage-backed securities so quickly that they never put their shareholders' capital at risk and, hence, did not have the incentive to evaluate the credit quality of what they were selling."

Acting Director DeMarco, isn't one of the fundamental lessons of the financial crisis that catastrophic danger can be created when lenders are allowed to avoid all risk and, in essence, all accountability for their actions?

Mr. DEMARCO. I think that is certainly a concern here, Mr. Cummings. The only thing I would moderate in that is that actually, whether we did not have the form of risk retention that Dodd-Frank has, yet many of these, virtually all of these issuers, securitizers, and loan originates of these awful mortgages were retaining risk in some fashion because they have virtually all gone out of business. The managers and owners of the firm have lost their capital. The risk retention in other forms through things like representations and warranties, they didn't work as well as they should have, and some of the panelists have pointed out. But your point is basically well taken, sir.

Mr. CUMMINGS. Let me ask you this. While we can debate additional policy proposals that would provide further safeguards within the securitization process, are we at risk of repeating the conduct which led us to the 2008 financial crisis unless there is some form of risk retention? I understand you are saying there is already some.

Mr. DEMARCO. Yes, sir, I think that risk retention in some form may be an important part of a better operating system going forward. But I think the other things that are being raised at this hearing, including improved transparency and disclosure to investors, is also absolutely critical to avoiding the kinds of problems we have had.

Mr. CUMMINGS. In other words, Ms. Ratcliffe, there is nothing wrong with having both, is that right, having the transparency and the risk retention? Because when I think about what our country has gone through, almost brought to our knees based upon what has happened here, it seems like we would err on the side of protection and being very careful, as opposed to just having one or the other. Transparency I just don't think is enough. Ms. Ratcliffe.

Ms. RATCLIFFE. I would agree. Again, there is a whole host of problems to be solved. Transparency will solve some of them. And again, as I mentioned in my comments, transparency for investors is not the same thing as transparency for borrowers, which also needs to be seen to. Risk retention is part of the solution. Standardization fits within that as well, because if you have well understood product parameters and structures, both for borrowers and investors, that also enhances their ability to use the data they have to accurately assess risk and compare risks and price loans and comparison shop.

Mr. CUMMINGS. Well, let me ask you this, so we do indeed have some agreement that a policy of risk retention, something that we achieved last Congress with the enactment of Dodd-Frank, is a necessary safeguard against the market practices which led to the financial crisis. I know some of you all may disagree; I see you shaking your head, Mr. Rosner.

Ms. Ratcliffe, The Wall Street Journal commissioned a study which found that 61 percent of subprime loans originated in 2006 went to people with scores high enough to qualify for a prime loan with far better terms. Isn't it true that the originate-to-distribute model ended up pushing countless consumers into more expensive and, thus, riskier mortgages than the consumers were eligible for based on their credit scores and other characteristics?

Ms. RATCLIFFE. It would appear so, and I would add that in my comments I mentioned the 30-year fixed rate mortgage, which is a good example of transparency and standardization. This is a product which, in and of itself, makes for a safer loan. Over time, the borrower's debt to income improves; as the loan pays down, the borrower's loan to value improves; so it inherently enables greater number of households to sustain home ownership safely.

It also enables a potential homeowner or potential mortgagor to be able to compare one loan to another in the Sunday paper or online very easily because there is really only one factor, so it is much easier to know if you are getting a good deal or not. Once borrowers were led into a marketplace that had much more complex products and features and options to consider, like the starter rate and the teaser rate and the maximum lifetime payment and so on and so forth, it made it much more difficult for them to make good product selections, and that introduced a level of systemic risk, especially with the adjustable rate mortgage features. When rates changed and borrowers could no longer afford to make their products, that is a level of systemic risk that better product standardization and transparency could have alleviated.

Mr. CUMMINGS. Thank you, Mr. Chairman.

Mr. MCHENRY. I thank the ranking member and I recognize myself for 5 minutes.

Dr. Sanders, Mr. Rosner, this question is directed to you. In my opening statement I referenced the fact that Fannie and Freddie are exempt from this 5 percent risk retention. Currently, we just recently wrote a check, or the Treasury, the American taxpayer is in, just in the last week, for over $8 billion for Fannie and Freddie. This was after we are in for many, many multiples of that currently. What problems do you foresee with Fannie and Freddie being exempt from this risk retention rule? How do you foresee that playing out?

Mr. ROSNER. At a time where we hear Treasury and the administration talk about reducing the role of FHA, Fannie and Freddie, and trying to revive private markets to exempt Fannie and Freddie from the risk retention rule will actually only support and enhance their dominance in the market and will create an arbitrage where private lenders will have an enhanced or a necessary situation where they end up having to sell to the enterprises.

Mr. MCHENRY. Why?

Mr. ROSNER. Because the enterprises actually are considered already to fully retain the risk; therefore, they don't have to play in the risk retention.

Mr. MCHENRY. No, no. I mean why would private entities not be able to compete with that?

Mr. ROSNER. Oh, because private entities would end up having an unfair economic disadvantage of having to compete by holding a 5 percent position against the enterprises who don't.

Mr. MCHENRY. OK. Thank you.

Dr. Sanders.

Mr. SANDERS. I would clarify that. I agree with what Josh was saying, but it is still clouding them again. Once you exempt Fannie, Freddie and the FHA from risk retention rules, the originators and securitizers, if they are forced to hold this and they have to make a decision between holding 5 percent or getting rid of it and giving it to Fannie, Freddie and the FHA, we have made it a very clear path and an easy path just to keep Freddie, Fannie, and the FHA at 95 percent market share; and I think that goes against what the administration has said they wanted to do. I almost call this the Fannie-Freddie enabling act, as opposed to Dodd-Frank.

Mr. MCHENRY. Mr. DeMarco, do you agree with these sentiments?

Mr. DEMARCO. Thank you, Mr. Chairman. As one of the regulators responsible——

Mr. MCHENRY. As the overseer of Fannie and Freddie?

Mr. DEMARCO. As the overseer and one of the regulators responsible for putting out this proposed rule, if I could just clarify a couple things. I am sorry this strikes folks as technical, but it is the way we view it. Fannie and Freddie are not exempt from risk retention. The proposed rule stipulates that because Fannie Mae and Freddie Mac actually retain 100 percent of the credit risk in the mortgages——

Mr. MCHENRY. Actually, to correct you there, the American taxpayer has 100 percent of the credit risk.

Mr. DEMARCO. Yes, sir, and I am incredibly mindful of that, and we are working very hard to protect the American taxpayers' investment in these companies. But the rule, what the statute requires is for the securitizers, the issuer of an asset-backed security, to retain a portion of the credit risk, and the regulators have simply acknowledged in the proposed rule that Fannie Mae and Freddie Mac, when they issue a mortgage-backed security, they are retaining 100 percent of the credit risk. To the extent that one wants to see their portfolio begin to shrink and reduce their footprint, forcing them to buy back or hold 5 percent of the securities that they issue is actually going to inflate their balance sheet. And while I am very supportive of the notion that we need to move the U.S. mortgage market away from one that is so much reliant upon government-related entities, I am not sure risk retention is the most effective or practical means for starting to move the government out and restore private sector participation.

Mr. MCHENRY. What is?

Mr. DEMARCO. I think that having the Congress of the United States take up a comprehensive housing finance reform where we can figure out what the ultimate resolution of Fannie Mae and Freddie Mac are going to be as part of it.

But the other thing is to really get private capital to come back into the U.S. mortgage market and be willing to evaluate price and undertake mortgage credit risk, those investors, that private capital is going to want to know what are the rules of the road and what is the long-term role of the U.S. Government in the housing market, and those investors are going to want clarity about where the government is limiting its involvement and just what is being really put back as available for the private sector so that it is not competing with entities that are operating with direct support and involvement from the U.S. Government.

Mr. MCHENRY. Mr. Rosner, back to you. In terms of the QRM, currently private mortgage insurance is not a part of this solution or this definition under QRM. Can you discuss would that have a negative impact, do you think?

Mr. ROSNER. Well, the private mortgage insurance industry has demonstrated that it offered no economic value in risk transfer. They were used largely because of the 1992 act, which required the 80-plus LTB to get credit enhanced on the enterprises. In the private market they haven't really been used. They have been not demonstrated to have been effective in underwriting their rescission rates on claims have been extraordinarily high, and most of them are operating under waivers with their State insurance regulators.

So the notion that private mortgage insurance has really helped the situation in any way I think is fallacious and I don't think there is any evidence of that, as witnessed by the economic performance of their insured loans relative to a broader pool of loans.

Mr. MCHENRY. My time has expired, but, Ms. Ratcliffe, it looks like you are interested in answering that question.

Ms. RATCLIFFE. Well, I would mention that the MI companies, through the end of 2010, paid $22 billion in claims to the GSEs, which is 14 percent of the taxpayer payments up to that point in time. So there is some economic benefit in that capital source market.

Mr. MCHENRY. Mr. Rosner.

Mr. ROSNER. That was with a rescission rate that was, across the industry, north of 20 percent at this point, it seems, and you are forgetting that they collected premiums. So really it was a return of, not a return on that insured premium.

Mr. MCHENRY. Thank you.

I recognize Mr. Quigley for 5 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman.

Director DeMarco, less than a month ago the Financial Services Committee held a subcommittee hearing entitled, Understanding the Implications and Consequences of the Proposed Rule on Risk Retention, at which your agency's chief economist, Patrick Lawler, testified, "One of the widely recognized causes of the financial crisis of 2008 was the poor quality of loans collateralizing many asset-backed securities, with subprime loan mortgages being the most flagrant culprits. Too often lenders made loans they would not have been willing to hold themselves only because they knew they could sell them to securitizers at an attractive price."

Are your thoughts and testimony consistent on that in your mind, with that statement?

Mr. DEMARCO. I am not sure where that statement is attributed to, but yes, sir.

Mr. QUIGLEY. It was in his testimony.

Mr. DEMARCO. It was in Mr. Lawler's testimony?

Mr. QUIGLEY. Yes.

Mr. DEMARCO. I think that is consistent with what I have in my testimony, sir, about part of the problem that led to both the housing crisis and the economic crisis was the bad underwriting that led to loans being securitized and certainly a securitization model in the private label market that was pushing these loans through to investors and really a reliance upon the notion that house prices were going up, rather than really doing due diligence and good credit review of the loans to ensure that the borrowers had the capacity to repay and had a credit history to suggest that they would.

Mr. QUIGLEY. Does that strike you, back to the question you were answering earlier, that transparency is an important asset in all of this, but it is not mutually exclusive with proper securitization? Wouldn't the two go hand-in-hand?

Mr. DEMARCO. Yes, sir. What I would like to say about transparency is if the public policy objective is to see private risk capital re-enter our mortgage-backed security market in a meaningful way so that mortgage credit risk is backed by private capital, not by the government, for that to succeed, one of the necessary steps is for those investors to have access to a much more robust set of data both at the time of origination of the security and throughout the life of the security so that those investors can properly evaluate and price the mortgage credit risk and prepayment risk of those mortgages. So we clearly have a lot of work to do to enhance the disclosure regime, the transparency for private label mortgage-backed securities to really be able to function in a robust way in this market.

The risk retention that has been proposed and was implemented in Dodd-Frank and that the regulators are in the midst of trying to implement now, what that is designed to do, in some ways it is to say, look, part of this problem that we had is really bad underwriting, we have been doing bad loans, and we want to get more accountability before that loan hits an investor in the form of a mortgage-backed security. We want someone else in that pipeline to have greater responsibility for the quality of that loan and the quality of the underwriting.

So what Congress settled on in Dodd-Frank is a risk retention requirement that puts that onus principally on the securitizer, and what Dodd-Frank says is the risk retention should be that the securitizer retains a portion of the credit risk because they are in the best position to be able to oversee and have some stake in whether the loan as originated is a good quality loan or not.

So that is how this is seen as an investor protection really designed to make sure, through this form of the securitizer, that the securitizer is paying attention to the quality of the loans, to Mr. Cummings' point earlier and to yours that there are loans that were being made here for which the people at the front end of the process appeared not to be doing anything in terms of proper diligence in making the loan.

Mr. QUIGLEY. Thank you.

Dr. Sanders, I am not sure if you got a chance to weigh in on the question that was asked, whether these are not mutually exclusive issues.

Mr. SANDERS. No, I have not been able to weigh in on that other than my testimony. But I think greater transparency is a great thing and it will help drive better pricing. And I agree with Mr. DeMarco it will attract better capital. My concern at the beginning was that I am concerned that risk retention sounds great, but it sends a false comforting signal to the market because, as I said, housing prices, if they fall again, is going to wipe out risk retention in the snap of a finger.

Second, the other issue is that the securitizers themselves can hedge risk retention. I know from my experience, when we would be holding the first loss pieces, we could go out and use either interest rate swaps or credit derivatives and just hedge out the risk retention. So, from our vantage point, it made it neutral.

But the point I want to make is I don't like the false signal that everyone suddenly thinks because we have risk retention, the days of bad underwriting and we don't need transparency. I am just worried about that being the case. But, again, transparency is good and beefing up the reps and warranties in case of violations is really an important step to go forward.

Mr. QUIGLEY. Thank you. I yield back.

Mr. MCHENRY. I thank the ranking member.

With that, we yield to Ms. Speier of California. She is not here, so Mrs. Maloney from New York is recognized for 5 minutes.

Mrs. MALONEY. Risk retention is basically having skin in the game, is that correct? Wouldn't you say they are holding on to a piece of it? That is the way loans used to be made in banks, and we didn't have a problem when that was done.

So I really don't understand, Mr. Rosner, in your testimony you express in your written testimony skepticism regarding the risk retention requirement in Dodd-Frank and whether the proposed rule will ensure better lending, better underwriting or safer markets. And in it you said, on the surface this appears to make sense; if a lender or securitizer knows he will have to drink the poison in the chalice he offers to others, then he would be more careful. That is one of your quotes. Am I quoting you correctly, Mr. Rosner, and correctly with regard to the reasoning behind the proposed rule?

Mr. ROSNER. You are quoting me correctly, but you are quoting the first part of the quote. If you continue on, what it says is the lender would have a, on the surface, increased interest in making sure the loan was appropriate, but as we saw in the case of Bear Stearns and Merrill Lynch, they died because of risk retention, and they didn't offload the risk, which would have been sensible if they really understood that they were creating poison. Instead, they retained it.

So, in a world where people are mismodeling or misconsidering or underconsidering, or don't even have the information to understand what risks they retain, as Stan O'Neal highlighted in his testimony to the FCIC, he didn't even realize that his firm retained the risk that it did. You are causing these firms to concentrating risk and several firms, therefore, to have highly correlated risks to each other; when, if you had lenders having the loans they made scrutinized by investors, the investors would price those risks at such a level where the likelihood is that loan would not be made in the future because it would not be purchased at a rate that could allow the borrower to afford it.

Mrs. MALONEY. Well, everybody is for transparency, but Chairman Bernanke testified before several committees that transparency is not enough, that some of the lending vehicles and some of the loans, some of the financial products are so complicated that people don't understand them. I even had before us in one hearing, we had the head of Freddie Mac say that he read his credit card disclosure statement, the fine print, for hours with his wife over dinner, and they couldn't figure out what it meant. So one way to make sure that the lender is a little more careful is if he has a little bit of skin in the game, I would think.

Now, how is it better that you have no skin in the game and all you are doing is getting a fee and moving it off the next day, so you have absolutely no skin in the game? It appears to me you would be more careful if you had risk retention, which has been the traditional way of banking. That is the old way of going to your community bank and getting a loan. Bankers were very careful in what they did because they were responsible for that loan.

But the way it became is that no one had any skin in the game; you collected your fee and went to Florida. And we lost $15½ trillion in household wealth. We almost went off the cliff. And most economists say that the fact that there was no skin in the game, no risk retention contributed greatly to it. So give me your thinking again on that so I can understand.

Mr. ROSNER. First of all, in the summer of 2001 I wrote a lengthy paper called a home without equity is just a rental with debt, warning that with the changes that we had seen structurally, which were being unrecognized, we would end up in exactly the place we did. The end of 2004, 2005, 2006 I spent time with people at the Fed, with people at Treasury, with people at various regulators warning that we had passed the peak and we were in for it. In February 2007 I put out a paper on the credit crisis that was about to happen in the CDO MBS market and how it would impact the real economy.

If you are asking me to defend the Fed's understanding of what was about to happen, or their look now at what happened, I won't do so. I will continue to say that if investors had the ability to properly price loans, the loans would be prohibitively expensive where the risks are too high for borrowers to take them, and that is a major part of the solution. It is the one that is the most honest answer——

Mrs. MALONEY. My time is running out. I just want to get one more question. In arguing against risk retention, you stated in your testimony, "To force investment banks to increase concentrations of held securities will only increase their risks." That appears to be exactly the point; it will increase their risks; their incentive to focus on better underwriting, better quality of securities and better outcome in the market. So if you increase their risk, wouldn't they be more careful?

Mr. ROSNER. Only if they are capable of assessing the risk. As we demonstrated in this crisis, most of them had neither the operational, nor modeling prowess to properly assess risk.

Mrs. MALONEY. You mean investment bankers could not assess the risk?

Mr. ROSNER. That is exactly right.

Mrs. MALONEY. That I find hard to believe. I mean, I think they understand risk more than most people.

Mr. ROSNER. Well, most of them aren't in business today because they didn't understand the risk.

Mrs. MALONEY. Well, also they didn't have skin in the game. They could just gamble.

Mr. ROSNER. No, Merrill Lynch and Bear Stearns did have skin in the game; Lehman Brothers did have skin in the game. Those who were able to rush to the exits and get their skin in the game out of the house in the few months prior to the full unfolding of the crisis didn't have skin in the game, but they too, prior to that, did have skin in the game, many of them, and would have met the same fate as those that are no longer with us.

Mrs. MALONEY. So you say the answer is more transparency.

Mr. ROSNER. I say the answer is allow investors to risk price because, again, the investors' interests are actually aligned with the borrowers' interest. Even now, as we are in crisis, the investor understands that a 20 percent principal write-down in many case many well make a lot more sense than a 70 percent loss given default, and it is oftentimes the investment bank or the servicer affiliated that doesn't want that to happen.

So the borrower and the investors' interests are tied, their interests are tied together because one has an interest in getting paid and the other has an interest in paying. So you need to make sure that they have the information to properly assess and price the risk.

Mrs. MALONEY. Well, I would say give them the information,——

Mr. MCHENRY. Thank you. The gentlelady's——

Mrs. MALONEY [continuing]. But give them risk retention too. I think that would be safer.

Anyway, my time is up.

Mr. MCHENRY. I thank the gentlelady, who is also a member of the Financial Services Committee. Thank you for your input and your questions.

I recognize the full committee chairman, Mr. Issa, of California, for 5 minutes.

Mr. ISSA. Mr. Chairman, I won't take 5 minutes, and I appreciate being recognized here.

Mr. MCHENRY. Well, I would be happy if you yielded me the balance of your time. I would appreciate that.

Mr. ISSA. And I shall, Mr. Chairman.

Mr. MCHENRY. Thank you.

Mr. ISSA. Having just come in, this may have been asked, but I appreciate the concept of somebody retaining skin in the game, but let me just ask a rhetorical question for a moment. Hopefully it won't take the chairman's time. Your certified public accountants don't retain skin in the game, even though they do an audit; they get paid, they provide a service.

In a sense, although we understand some of the things that went wrong in some cases, where people were packaging up and selling products, aren't there times in which what you really need is full disclosure, but ultimately, when you buy a car, the car dealer doesn't necessarily keep any skin in the game, but if he sells you a bad car, you go back to him. So as much as I appreciate the nature of the rule, don't we also have to have out clauses if certain other things are met? Mr. Rosner.

Mr. ROSNER. Yes. That is why, in my testimony, I feel very strongly that before a deal comes to market, investors should have a right to inspect the loan level data and there needs to be standardized pooling and servicing agreements, there need to be standardized representation and warranty agreements that really do define, on a collateral standardized basis, what the rights and obligations of various parties are. This is one of the things that Fannie and Freddie did do well.

Now, yes, they retained the risk; nonetheless, investors in their instruments fully understood that, deal-to-deal, they were actually contractually identical. We have a situation where you had as many as 300 different pooling and servicing agreements, each with different rep and warrants attached to it, leading to the crisis. And when people started seeing early payment defaults rise and jitteriness in the markets, people said, you know what? I am going to get rid of these positions because I don't have time to read 300-page documents, and I will come sift through the rubble on the other side. And, unfortunately, that led the stampede from which we are all suffering and the housing financing system came to a grinding halt as a result.

Mr. ISSA. I appreciate that.

As promised, I yield the balance to the chairman.

Mr. MCHENRY. I thank the chairman for yielding.

Mr. DeMarco, in terms of some of the steps you have taken in FHFA in terms of disclosures, there is a uniform mortgage data program, there have been some significant delays with that, but I do want to say thank you because these are significant steps for disclosures, but I also realize there have been some limitations with this.

Mr. DEMARCO. Well, when we announced it last May, we said it was a 2-year project, and we are continuing to push ahead and, in fact, there are some positive steps and results that have arisen from this. But it does take time, sir, and we are continuing to do it, and I do think it is an ingredient to the sort of things that you and the panelists have been talking about to have enhanced disclosure.

That assumes some things about the data that are being disclosed: Are the data consistently defined? Are they being reported in a consistent manner, regardless of who the loan originator is or who the appraiser is? So what this uniform data program is, it is actually sort of the foundation for this transparency we are trying to get within the marketplace, a uniform set of definitions and means of reporting data so that, regardless of who the originator is and who the securitizer is, there is that kind of standardization in the market, which should be able to make the transparency that we are all advocating actually work.

Mr. MCHENRY. Thank you.

Mr. Rosner, so in terms of transparency, what are the unintended consequences of transparency?

Mr. ROSNER. None.

Mr. MCHENRY. What are the unintended consequences of 5 percent risk retention?

Mr. ROSNER. I should correct that. I should correct the unintended consequences of transparency are that there is a thinner economic opportunity or a thinner margin for the issuers, and so they will have less of an arbitrage; it will negatively impact, to some degree, their income. But the benefits will be passed on both to borrower and investor by the narrowing of that spread.

Mr. MCHENRY. As opposed to a 5 percent risk retention, which raises the cost of credit for consumers, thereby if credit costs more, those that are extending it make more, right?

Mr. ROSNER. And I think to Dr. Sanders' point, the other risk of risk retention, besides the correlation in the increased cost, is that it may lead to an increased false sense of comfort that the work was done, again, by the issuer and, therefore, the investor doesn't have to focus on it as much.

Mr. MCHENRY. So rather than fixing this systemic risk problem, Dr. Sanders, in your testimony you say it actually creates more systemic risk.

Mr. SANDERS. That is correct, because the risk retention rules as written simply, just as Josh said, Mr. Rosner said that we have all sorts of problems it creates, false sense of security, it leads us down the wrong road, and those are big issues. But when we get back to the whole nature of what risk retention doesn't do, as I have said, Wall Street can hedge away that risk already. So it is not really a—or sometimes badly, and then they get caught stuck with the risk, but it can increase the systemic risk of the institutions themselves.

Can I add one more thing? If we are talking about trying to get loans to lower income households and more credit impaired households, I view risk retention and the QRMs as actually cutting people out of the market that want to get back in with somewhat impaired credit, etc. I don't think this is very good for consumers that have gotten, I think, 40 percent have had serious credit score degradation. This isn't going to help; this is going to make it worse. With full disclosure of information and no risk retention, then we are aware exactly what the subprime loans are, then I think the private sector can move forward with that and that is the good solution.

Mr. MCHENRY. Have you looked at, for instance, auto financing or subprime auto financing, securitization?

Mr. SANDERS. Yes.

Mr. MCHENRY. Did that world fall off and look like the housing securitization?

Mr. SANDERS. Housing was something completely different because the automobile industry didn't have all price of cars fall 60 percent at once, together, not in all areas. But, no, housing was unusual because it fell off a cliff, and that is why risk retention wouldn't help that. But again, reps and warranties——

Mr. MCHENRY. But how are they able to actually have subprime securitization for autos, for instance, and people are buying this, people are purchasing, sophisticated investors are purchasing these things? Mr. Rosner.

Mr. ROSNER. First of all, you have to remember the difference in the duration of the asset. You are talking about a 30-year mortgage versus, typically, a 60-month auto loan.

Mr. MCHENRY. So that is the only difference?

Mr. ROSNER. That is a major difference. The auto industry also, the non-captive lenders, really did learn their lesson in the late 1990's; they went through a crisis very similar. Obviously, it had less broad economic impact to what the mortgage originators did recently. Both actually blew up, the original subprime mortgage industry and subprime auto finance industry both blew up in the late 1990's, and the auto industry ended up sort of reconsolidated mostly by the captives, so there was much more by way of control. But again the duration, I think, is the biggest difference.

Mr. MCHENRY. OK. Interesting.

With that, Ms. Speier is recognized for 5 minutes.

Ms. SPEIER. I have a somewhat facetious question to ask you, no, I think all of you. Have you just missed out in the last 3 or 4 years altogether? I spent 3 years on the Financial Services Committee, thousands of hours, literally, hearing testimony over and over and over again, and everyone said the same thing on both sides if the aisle: if you don't have any skin in the game, it is real easy to play the market. And it just seems like it is common sense.

Now you, Dr. Sanders, suggest that if there is full disclosure, you really don't need risk retention. Full disclosure to whom?

Mr. SANDERS. Not quite. I am saying you need full disclosure plus you need to tighten up the representations and warranties to protect the underwriting. And again reps and warranties already gives skin in the game. That is what I am puzzled about.

Ms. SPEIER. Excuse me. Full disclosure to whom?

Mr. SANDERS. Full disclosure to investors.

Ms. SPEIER. To investors. All right. Do you think that the investors that invested in Goldman Sachs, in their Abacus deal, I think it was Abacus, in which they were, for another client, shorting the same product that they were promoting in the market? Do you think that was full disclosure?

Mr. SANDERS. No, I don't think it was full disclosure. But then again it comes back to what investors would invest in Abacus when they couldn't see what was inside of it. That has always puzzled me.

Ms. SPEIER. Now, full disclosure oftentimes to the public, and certainly to government, is full disclosure to the regulators so they can, in fact, oversee what is going on. And I am reminded that when AIG was profiting handsomely from CDOs through their financial products division in London and had stretched themselves to immeasurable places, I asked the question did the Office of Thrift Supervision know what a CDO was, and they answered no. So I think that it is very simplistic, frankly, to suggest that somehow full disclosure is the panacea.

The American people aren't stupid and the American people get it. If you don't have skin in the game, if the banks don't have to retain some form of risk, then why wouldn't you sell garbage over and over and over again? Because you have no skin in the game; you have nothing to lose. If you and I were to flip a coin and it was tails, you win and heads, I lose, why would I play with you? But that is what you are somewhat suggesting.

I apologize for not really asking a question, but let me just respond to and ask your comments. The Financial Crisis Inquiry Commission, many hearings, reviewed many documents, and in part of their report they said, on Wall Street, where many of these loans were packaged into securities and sold to investors around the globe, a new term was coined: IBGYBG, I'll be gone, you'll be gone. It referred to deals that brought in big fees up front while risking much larger losses in the future, and for a long time IBGYBG worked at every level.

I guess I would just like you to comment on that. Mr. Rosner.

Mr. ROSNER. First of all, there are typically four risks that regulators consider: operational risk, liquidity risk, credit risk, and reputational risk. And all of the firms that really abused the reputational risk in exactly the way you are talking about are the ones that really did go out of business.

Ms. SPEIER. You think Goldman Sachs had a reputational risk?

Mr. ROSNER. Well, hold on, no. Now you are going back to the question on the Abacus deal, and that actually, the transparency, the collateral would have actually been helpful and transparency to the other side investor seems to be a different issue, and that may be a securities issue. It seems that the SEC felt it was potentially, and addressed it as such. But even there I would point out that we get back to the same issue, which is if investors had the information available to them to do the full analysis, they would have and might not have participated in that deal. We are talking about qualified institutional buyers; these are sophisticated investors.

And I will add one last piece, which is regarding whether the regulator did know what was going on with AIG. I would point out, as I pointed out——

Mr. MCHENRY. The gentlelady's time has expired. I will give the gentleman the opportunity to finish the question.

Mr. ROSNER. In an early 2007 paper I wrote, I highlighted the fact that none of the Federal financial regulators had access to the CDO deal data because none of them were qualified institutional buyers. The first was the FCIC, and that didn't happen until 2007. That is a problem with transparency.

Ms. SPEIER. Mr. Chairman.

Mr. MCHENRY. Yes.

Ms. SPEIER. I realize my time has expired, but I am just curious, and if you think it is appropriate to ask the question, maybe you will ask it. I am wondering if any of the panelists feel that——

Mr. MCHENRY. Well, you are asking it, so go ahead and ask. It is fine. Just the two of us here; we can work this out.

Ms. SPEIER. Good.

I am curious that you believe that there are institutions now that are too big to fail in this country, and what is the remedy?

Mr. MCHENRY. We will ask the whole panel. I would be interested in everyone's comment as well. Good question.

Mr. ROSNER. Absolutely. No question. It is one of the things that, as a financial service industry analyst, bothers me the most. I would have loved to have seen Dodd-Frank include a simple paragraph that said any institution that requires extraordinary government asset purchase, debt guarantees or more than 60 days at the Fed window would be operating under immediate supervisory action and their executives and board would be prohibited from employment in the financial service industry for a period of 5 years in any capacity.

I think that would have forced them to decide either to shrink themselves to a point where they were manageable or increase their expenditures on risk management to make sure that they dealt with their risks. But we have chosen to pretend that they are not to keep them afloat and, in fact, to codify their too big to fail advantages in many parts of Dodd-Frank.

Mr. MCHENRY. Dr. Sanders.

Mr. SANDERS. Well, yes, of course there are too big to fail firms, but one thing I want to point out is that the chairman of the Federal Reserve, Chairman Bernanke, and the Federal Reserve system already had the regulations in place to prevent too big to fail, and they just chose not to follow their own regulatory guidelines.

Mr. MCHENRY. Ms. Ratcliffe, if you would like to comment as well?

Ms. RATCLIFFE. I think to some extent it is not just institutions, but systems that sometimes we just can't afford to let fail, and I think the important thing is to recognize those and proceed accordingly, rather than pretending that there isn't a situation where government is going to have to step in to keep systems afloat.

Mr. MCHENRY. Mr. DeMarco, I don't know if you want to jump into that one. Not that you have enough balls in the air.

Mr. DEMARCO. I don't believe any firm should be considered too big to fail, and I believe that under Dodd-Frank the regulators have been given tremendous challenge and set of responsibilities to ensure that we operate the oversight of a financial system in the future so that institutions are not too big to fail. And it will remain to be seen what we are doing now to implement our Dodd-Frank responsibilities to see how this works, but I do not believe that institutions should be considered too big to fail, and I believe Congress has challenged the regulatory community with that objective.

Mr. MCHENRY. Mr. DeMarco, I have two final questions for you, if I may. If many players get out of the mortgage securitization business because of this risk retention, holding this capital, how does that play out? Does that make it better for the consumer or worse?

Mr. DEMARCO. Currently, virtually all mortgages being originated, well over 90 percent are being securitized through Fannie Mae, Freddie Mac, or Ginnie Mae, so implementation of the risk retention rule, even as proposed, in the near term, until we reach a resolution of conservatorships with Fannie and Freddie, will have limited impact.

So I think that, combined with the fact we put out a proposed rule here and asked over 170 questions, so the regulators are looking for a lot of input from the marketplace from the whole array of stakeholders in this and people that have a view. Panelists here have expressed views. I expect we will be getting comments like that, comments coming from different angles, and I believe that the group of regulators charged with implementing this fully intend we are expecting a considerable volume of comments and we intend to take a very careful review of that. It is not that common to ask 170-some questions in a proposed rulemaking. The regulatory community is looking for input so that can better inform what we do in terms of the final rule.

Mr. MCHENRY. So how does this risk retention rule add value?

Mr. DEMARCO. Sir, the intention that Congress had in doing this I think has been pretty well debated on each side here, but it is intended to add value by making an explicit statement and creating an explicit particular structure so that issuers of asset-backed securities retain credit risk here so that they will better discipline and pay greater attention to the underwriting that is done at the time of loan origination to enhance the quality of the loans that are then pooled and sold to investors in asset-backed securities.

That is the theory we are operating behind here and that is the intended outcome. It does certainly seem to better align the incentives. There are some legitimate concerns that panelists here and others have raised, and the regulators are going to take a look at that to see whether the proposal ought to be changed in any way.

But we are operating with a given statute that says several things: it says that the risk retention is focused on the securitizers, it says—I would like to correct one thing that was said earlier. The securitizer with their retained risk is, under the law, not allowed to hedge that risk. And we are going to get a lot of comments to see what the market participants view as the potential implications.

Mr. MCHENRY. So that is, to Mr. Sanders' point, the systemic risk element added here. If you can't hedge that risk, financial institutions, do they seek to hedge as much of their risk as they can? I am asking this rhetorically. Of course you do. If I have an asset, I want insurance on it. I think most people do that.

Dr. Sanders, I do want to ask you this because in the previous securitization market—let's just go back a couple years—in order to sell a securitized product on the market, you have to first sell really the mezzanine, right, before you can really sell—that is sort of the first piece you have to sell. So many firms would retain that in order for them to sell off, basically that first loss position they retain.

Mr. SANDERS. Yes. It has been industry practice in any deal I have ever seen they usually retained at least 5 percent, and sometimes up to 20 percent of the deal in the private label market. We are not talking about agencies. That has always been the case.

Mr. MCHENRY. OK. So what would be the problem of saying this is a bank regulation, for instance, going back. You realize that banks are holding more capital on the books, so you raise the regulatory amount that they have to hold on their books, and what do banks do? They then raise the amount of capital they hold beyond that because they don't want to purchase that regulatory mandate, right? Why not just simply recognize what the market is doing and say that is great and this rule doesn't have a major impact? What would you say to folks who would say that?

Mr. SANDERS. I would say the private sector had already been doing that as industry practice, and the whole housing price crash wiped out even their first loss pieces, as we know. Those got torched very early on. So it not even effective. But what my concern with now going through and stating a 5 percent regulatory is that we will see, suddenly, everyone maybe even shrink from 20 percent risk retention and go down to 5 percent. So this could actually make institutions more risky, to hold less.

Mr. MCHENRY. Ms. Ratcliffe, do you agree? Disagree? What are your comments?

Ms. RATCLIFFE. I disagree. There is going to have to be capital to support the risk somewhere in the system.

Mr. MCHENRY. Where does that come from?

Ms. RATCLIFFE. Well, it can come from a number of sources, but it has to be out there and it has to be a level playing field. And for nobody to take any risk on the loans is not going to help us. I think we did see a lot of people try to hedge their risk and think they laid it off on somebody else who thought they knew what they were doing and they thought they had enough transparency and they thought they had good enough models, and they were wrong.

Mr. MCHENRY. So basically your answer is simply we need Fannie and Freddie back, because that makes it all work. That seems interesting to me.

Dr. Sanders, would to respond to that?

Mr. SANDERS. No. Actually, we are going through—Mr. DeMarco made an excellent point. We have to get private capital back on the mortgage market, and I think Freddie, Fannie and the FHA, bless their hearts, unfortunately with a guarantee, are keeping rates so low, I mean, basis points over Treasury rates, that if we want to attract capital back, we actually have to kind of have more private sector participation without the guarantee that will boost yields and attract investors back. So I really want to go with what the administration said earlier, start pairing them down, if not dismantle them.

Mr. MCHENRY. Mr. Rosner.

Mr. ROSNER. I totally agree with that. You know, there is a truth that doesn't want to seem to be heard on Capitol Hill, which is mortgage rates have to rise. And no one in Washington wants to accept that as the necessity or as the reality required for private capital to come back. That is what is going to have to happen, one way or another, to revive a private label market or even have a properly risk priced government supported market.

I would also point out, though, that there were, and I agree with Ms. Ratcliffe in terms of capital is a big piece of the answer, and would also remind you that a lot of the problems that we saw, sort of secondary and side effect problems that we saw, were arbitrages on the difference between regulatory capital requirements of various parties. If you remember, the insurance regulators had much lower capital level requirements than the Federal regulators, and that became an opportunity to arbitrage or theoretically transfer risk to insurers who weren't capitalized enough to hold those risks.

Mr. MCHENRY. All right, Ms. Ratcliffe, I want to give you an opportunity to followup or respond to that, if you would like. And then I realize Mr. DeMarco has had to leave, so we have one final question for the whole panel. But I do want to give you an opportunity to comment.

Ms. RATCLIFFE. Yes. I want to just say that I think the transparency and risk retention accomplish sort of complementary, but different, things, and the other thing that together that they can help do is just reduce the overall amount of risk that the system takes on. These are, really, the natural market mechanisms that ought to dampen the willingness of all parties along the spectrum to take on risks so they wouldn't necessarily take on the same magnitude of risks they took on back in 2004 to 2006. So in that case I would argue strongly that the net effect of both of those would be overall reduction in systemic risk.

Mr. MCHENRY. OK. OK. Obviously there is some disagreement on that from the panel, but my final question, and we will start with you, Ms. Ratcliffe, and go right down the line, final question, I promise: Do you think that the most powerful tool to address this challenge, to address this problem, the most powerful tool, market-based tool would be transparency?

Ms. RATCLIFFE. And the challenge is, sir?

Mr. MCHENRY. Well, the challenge is—I don't know if you have been—this question of securitization, private sector—OK, let me give you context. In light of Fannie and Freddie and the government being 90 percent of the mortgage market, with Mr. DeMarco having the largest housing portfolio in the world under his control, and I would say we realize you do not seek such. This is not part of ambition, we understand; we realize you have one of the most challenging jobs in Washington. But in light of that, is transparency the most powerful tool to make sure that we can have a private sector market for mortgages?

Ms. RATCLIFFE. I think it is——

Mr. MCHENRY. Yes or no? I mean, if you think no, it is fine, and we can keep rolling here.

Ms. RATCLIFFE. I will say that I think there are some better tools.

Mr. MCHENRY. Such as?

Ms. RATCLIFFE. Capital, regulatory capital, level regulatory capital playing field.

Mr. MCHENRY. So 5 percent is good?

Ms. RATCLIFFE. That is not adequate necessarily for systemic capital.

Mr. McHENRY. Ten?

Ms. RATCLIFFE. It depends on the types of risk the system takes on.

Mr. McHENRY. Twenty?

Ms. RATCLIFFE. That would depend entirely on the risk profile of the loans that were made. I would suggest that would represent a fairly high risk market that we wouldn't want to return to, that level of inherent risk.

Mr. McHENRY. Mr. Rosner.

Mr. ROSNER. If you are talking about to solve the problems of the securitization market itself and the risk transfer, yes, transparency in a standardized, manageable format with corresponding standardization of contract and representation and warranties I think are the best solution.

Mr. McHENRY. Can that be done in the private sector?

Mr. ROSNER. It absolutely can be. Unfortunately, I think that task has been led not with investors' interests at core, but with issuers' interests at core. So I think that we need to see that paradigm changed or regulators need to get more involved to foster an environment where that is being created on behalf of the investor community.

Mr. McHENRY. Dr. Sanders.

Mr. SANDERS. I would say transparency absolutely is the most important one. And again I am just going to say one last time I think for those households that have credit impairment after the housing bubble crash, I think risk retention rules are going to work in the exact opposite direction; it will cutoff credit to households that really want it, and that really scares me.

Mr. McHENRY. Mr. DeMarco.

Mr. DEMARCO. To have private at-risk capital invested in asset-based security undertaking that credit risk, having transparency is essential. But if I may go further, it is essential that there be full and appropriate and high-quality data there. To some of Mr. Rosner's points, there does need to be attention to standardization, to terms of contracts. There may be a role for government in doing that because the government can take a look at all the stakeholders, not just one party. But one might argue as well that would be executed by private groups doing it.

But I do think that transparency, it is not just being transparent, but what is it we are being transparent about? There has to be the right data properly and timely disclosed and understandable to the investors. That is the full definition of transparency that would be essential for private risk capital to really return to investing in mortgage-backed securities where they are undertaking the actual mortgage credit risk.

Mr. McHENRY. Well, thank you. I appreciate your time.

I am sorry. Yes, I recognize the ranking member.

Mr. CUMMINGS. I have been patiently waiting.

Mr. McHENRY. And I would say to the gentleman that Mr. DeMarco's time, we have pushed him beyond his time, so if you start with him and let him go, he would probably appreciate it.

Mr. CUMMINGS. Oh, sure. I certainly will do that.

Mr. McHENRY. I recognize the ranking member.

Mr. CUMMINGS. I want to understand, Mr. DeMarco, when you say transparency and then I hear Mr. Rosner say some people that I would expect to understand the stuff that is transparent don't understand it. I am confused. You just said a moment ago that I think you said the investment bankers. I don't know, I can't remember who you said. The question was asked who would understand. In other words, if that information was available, would folks understand it, and you can correct me if I am wrong, I could have sworn you said there are certain people that would not. No?

Mr. DEMARCO. I don't think I said that.

Mr. CUMMINGS. OK. So if we had transparency—let me go to you, Ms. Ratcliffe, and then I will come back to you, Mr. DeMarco. The transparency, who would benefit from that, Ms. Ratcliffe?

Ms. RATCLIFFE. We have talked a lot about transparency to investors.

Mr. CUMMINGS. Right.

Ms. RATCLIFFE. But I have also, in my comments, addressed the importance of transparency to borrowers. I think you need to have both. Transparency should be to the benefit of both ends of it. I still believe that accountability is critically important to the equation, and transparency without accountability may not get us anywhere.

Mr. CUMMINGS. When I talk to my community banks, they have skin in the game, and the community banks in my district that I talk to said that their problem was not mortgages. The problem was mortgages from the standpoint that maybe people couldn't pay them back, but their problem was other things like people losing their jobs and unable to make the car payments and all that kind of stuff.

So when a lot of people think about skin in the game, they think about their community banks, and the community banks had an interest; they serviced their loans, they made sure that they didn't give no-doc loans, and they knew that they would be out of business if they gave enough loans that were toxic. So to the layperson it seems like it would make sense for somebody to have some risk here.

And then, Mr. Sanders, you were talking about people who want to come back into the game. Well, a lot of people I am talking about won't be in a position to get back into the game, period, maybe even in a lifetime. So I am trying to figure out—and then I think about the fact of all these people who have lost so much, and I still don't think that a lot of folks get how significant this foreclosure problem is. Sometimes I wonder whether there is a disconnect with the people out there who are losing their houses and basically that is all they had.

So I am trying to figure out why don't we err on the side of making sure, again, going back to the community bank thing, making sure that these folks have some kind of incentive to do the right thing and due diligence and all that kind of stuff, and have layers of protection, layers of different sets of eyes. You follow me? Am I missing something?

I will start with you, Mr. DeMarco, since you have to go. You look like you are straining to understand what I am trying to say.

Mr. DEMARCO. No, sir.

Mr. CUMMINGS. OK, good.

Mr. DEMARCO. I believe I understand what you said, and I would echo several things. I think that there has been a real damage to thousands of families across this country as a result of many difficulties and problems in the way our finance system was working earlier this decade. And I think the toll on American families and on their communities, on their neighbors and so forth, has really been stunning, and there are some communities that are going to take many years to recover from this. And I think that is something we all should be very concerned about, and certainly for our agency we are doing our best with foreclosure alternatives to try to help as many people stay in their homes as they can.

Second, with respect to community banks, if I could make a larger point that I think may resonate with some of the concerns you are raising, when I look at the mortgage market today and the way it is structured, I see tremendous concentration. I see concentration in mortgage origination, I see tremendous concentration in mortgage servicing, and it does make me wonder where is, as we contemplate changes to the country's housing finance system, that we go about that in a way in which the role of the community bank, the community lender is not shut out and, in fact, we think about ways to better foster the involvement of community lenders in not just making loans, but continuing to service loans in their community. They have the direct touch with the borrower and they are in a good position to be able to understand the borrowers' needs and help them before they get into trouble.

So I think about some of the things we have done, sometimes meaning to be prudential in our actions, has led to a concentration that is actually causing or could be said to be causing harm in our communities, and I think as we go forward and think about housing finance reform, what is going to be the role of government in housing finance, what is the post-Fannie, Freddie world look like, I think we should be very mindful of the role of community lending institutions and that we don't, in an effort to tighten things down everywhere, create an environment in which community institutions cannot participate and be robust and constructive participants, whether it is in housing finance or other parts of consumer finance.

I hope that is responsive.

Mr. CUMMINGS. Yes. It is very helpful. So they are the ultimate skin in the game folks, right? Am I right, Ms. Ratcliffe?

Ms. RATCLIFFE. One of the——

Mr. CUMMINGS. Mr. DeMarco, I don't want to hold you up. My time has run out anyway, but——

Mr. MCHENRY. I would say to the ranking member if we could dismiss Mr. DeMarco.

Mr. CUMMINGS. Yes, of course.

Mr. MCHENRY. I want to thank you for your service to your government. I appreciate your testimony today. Thank you for dealing with the schedule as well, and we apologize for that. Thank you.

Mr. DEMARCO. Well, thank you very much, Mr. Chairman and Mr. Cummings. I appreciate being excused, but my staff and I are fully prepared to followup in whatever way would be helpful to the subcommittee.

Mr. CUMMINGS. Thank you very much.

Mr. DEMARCO. Thank you so much.

Mr. MCHENRY. With that——

Mr. CUMMINGS. You were getting ready to answer my question, Ms. Ratcliffe?

Ms. RATCLIFFE. Yes. Certainly to the extent that if community banks are willing to take the 5 percent risk or hold the loans on portfolio and take 100 percent of the risk, they are the ultimate skin in the game. And I think this speaks to one of the points we haven't addressed much here today is the alignment on the servicer side that there is also some provisions for in the risk retention rules, that there is evidence that lenders who are servicing their own loans in their own portfolio tend to be more likely to pursue remedies that keep the borrowers in their home and minimize losses all around than those who are servicing for others. So that is another one of the alignment of interest problems that risk retention could seek to address that really full information doesn't get at.

Mr. CUMMINGS. Just one last question. Going back to what you just said, 5 percent seems like a little bit compared to what a community bank would be dealing with. So I am just wondering if you are going to have a retention, do you think 5 percent is sufficient? In other words, to do the things that you just said, what you just said, about them servicing and try to keep the borrower in the house and all that kind of stuff, it seems like the bigger the bank, the less—it seems like they are much further away. And I just base this on what I see in my community. They are much further away from the borrower, so you don't have those relationships. So I am just saying 5 percent, I wonder if that even does it. You follow me?

Ms. RATCLIFFE. Of course, it is hard to know, but I believe that relatively modest amounts of risk retention are effective, especially when structured right, and the regs have a number of different alternatives for looking at the structure, are enough to begin to get at some of the principal-agent problems. They are not necessarily going to be enough to protect the entire financial system, and that is sort of a different objective, is having enough capital systemwide to pay for the losses than just the behavioral aspects of a risk retention model.

I would also add that small institutions can participate in the mortgage market by holding loans in portfolio, potentially provided. We will see how the regs come out, maybe by keeping some of the risks in securities. They can also participate by selling loans to Fannie and Freddie, and those agencies right now, and hopefully some kind of successor function, would allow smaller institutions to continue to offer the same kinds of products in communities around the country that the large banks can offer competitively.

Mr. CUMMINGS. Mr. Rosner, you had something?

Mr. ROSNER. Yes. The community bank, I think, has been a very different type of player and, yes, they do retain the risk. Not only do they know their customer, they know the customer's company, usually; they know the local economics of the market in which they are lending; they have a lot more information with which to assess risk and, therefore, for many reasons have much more comfort in holding that risk.

The large firms, when you have, as we saw, an increasing concentration of loans that are being made by a handful of players such that, as of now, last quarter, 56 percent of originations were done by three players, if you think that a lender in California knows anything of substance about a borrower in New York or any other community, he really doesn't, it is just a number. And when you have firms that are inherently too big to fail, they know that even if they are forced to retain 5 percent, it is not their 5 percent, it is the taxpayers' 5 percent.

So we haven't addressed that. And the risk retention, as I said before, I fear is almost a false sense of comfort because, as we saw even in the FCIC report, a lot of the senior-most managers of many of the firms did not even understand or know, and weren't apprised of the risk that their firms retained as it was, in many cases risks that ultimately sunk those firms. So I think, as Mr. DeMarco pointed out, we do have to figure out a way to get deconcentration of lending, deconcentration of servicing. And I am just not sure that in a world where we already have institutions that have extraordinary benefits and think of themselves as too big to fail, that giving them the right or almost the responsibility to hold more and more risk, holding the taxpayer more and more hostage, is the right answer.

Mr. CUMMINGS. Mr. Chairman, you have been quite lenient, but I have to say this. First of all, I want to thank all of you for your testimony; it has been very helpful.

I just hate the idea of, Mr. Rosner, kind of throwing up our hands and saying, you know, we cannot control this. That is what it seems like. And it just seems to me that in a Nation where we can send somebody to the moon, it seems like we ought to be able to straighten out this mess so that it doesn't happen again and so that it makes sense so that little people or regular just everyday people are not crushed. I mean crushed. And as I say to my constituents, I think what I am seeing right now probably is the greatest transfer of wealth in my lifetime from middle class to upper class. There is a tremendous transfer of wealth and it is really kind of sad, and it has come in so many forms, and foreclosures is one.

Thank you very much.

Mr. MCHENRY. And I appreciate the ranking member. If the Members do want to make a comment about the gentleman's statements, I am happy to hear it. Mr. Chairman, I have just been interested in the questions and good feedback, and I think we have had a good panel, and it is a good question. I mean, is that sort of the idea, Dr. Sanders, Mr. Rosner, Ms. Ratcliffe, just throwing up your hands and just say we can't do it, or what is that answer?

Mr. SANDERS. I will try this first. I moved here from Phoenix, Arizona, so about foreclosures, I am painfully aware of what it does to the community and how households suffer when that happens, and I have seen community banks out there just go away; and that is bad, because I am a big supporter of community banks for all the reasons Mr. Rosner said, which is very good.

But again I get back to the point that there really is something that we can do; it is strengthen representations and warranties, which is, by the way, the ultimate skin in the game, it is not 5 percent. Because what happens is if a bank such as Wells Fargo or one of their subsidiaries misleads investors, investors then file, and there are tons of these suits lined up in court and they will in some cases collect the money back.

And again, to go back to Mr. Cummings' question, you were saying, well, that is after the fact they will collect money. Well, going forward, if you strengthen these and make it clear that we will enforce these laws, we will enforce these regulations that are on the books and have transparency, we will see a lot different market going forward, but we really have to have those things. And that is not waving my hand; I want to move forward. I am just concerned that risk retention gets focused on and it doesn't achieve what we think it is going to do.

Mr. ROSNER. Many of the underlying problems that brought us to where we were were illegal activities, both on behalf at times of borrowers and at times of lenders. It seems that they exist in the servicing world as well. We have seen no enforcement, which I find to be astonishing. I have spent most of my, since leaving the traditional sale side, have spent my entire career highlighting and warning of exactly the issues that we have come to live with and doing analysis on that.

I am not at all throwing up my hands. What I am suggesting is that we have to avoid the false sense of solving something that we are not solving, and the closest we get is make sure that the information out there is so clear, so standardized and so manageable that you can't hide reality from either borrower or from investor.

Mr. MCHENRY. Ms. Ratcliffe.

Ms. RATCLIFFE. I agree with all that. I think that it is quite possible that if all we did was increase transparency for investors and let them run all these tapes and fields, records through their models, that too could potentially create a false sense of security. I mean, to your earlier point, I think the saddest thing about this situation is that it didn't really have to happen.

Why didn't the market ask for the reps and warrants then? Why didn't the private investors get those? Why didn't they get more information then? Mr. Rosner saw it coming. It seems like private investors could have used what information they had; they had enough information to be able to anticipate some of these events. You did.

Mr. ROSNER. They didn't really have the information, i.e., the information that we are talking about, the loan level information. And, unfortunately, I am not here to make excuses for the investor community, but the reality is you have a broad and very diffuse investor community, 10,000 or so firms who, to get them to even offer comment letters on rulemaking processes or accounting rules to which they are extremely exposed is almost impossible.

So you have that relative to a handful of firms who are ultimately making the rules, and there has been no regulatory intervention on behalf of the investor, who, by the way, harms—you have to remember that a lot of those people who have lost their houses have been doubly harmed because they have lost their pension assets, they have lost other investment assets. They have been harmed all along the way. They are investors. Most investors, most professional investors are managing money for many of those same people.

Ms. RATCLIFFE. So I agree with everything Mr. Rosner said. I just wanted to say that this is not rocket science. I think the mortgage finance system, for a number of years, really has worked fairly well for a lot of people and we do know what it is going to take to get it right. These are, in a lot of ways, common sense things, and this either/or discussion is a little misleading. We need the transparency; we need the risk retention; we need the skin in the game; we need the capital; we need transparency in markets. We know what we need here.

Mr. CUMMINGS. Thank you all very much.

Mr. MCHENRY. All right, thank you for your testimony. I appreciate the ranking member's questions as well.

I would just say, in closing, thank you for staying for an extended period of time. I certainly appreciate your candor in answering these questions. It is a highly important issue. And let's make no mistake about it, there is skin in the game, as there always has been with securitization, at all levels. The question is what can we do to foster more transparency in this marketplace.

Clearly, Dodd-Frank doesn't address this. I think the takeaway from today is that more transparency would not be a harmful thing to my constituents who seek a mortgage; it wouldn't be a harmful thing to investors, because they would at least have greater certainty in the products they are purchasing. I think those are some enormous takeaways that we can agree to in a wider array, so I certainly appreciate you addressing those issues.

It certainly is an important issue not simply here in Washington or on Wall Street, but for Main Street, for average Americans and average homeowners, even those that are paying their mortgage. But we want to make sure we get this right, and that is what this hearing is about, and I certainly appreciate your information, informing us as public policymakers about that.

Thank you, and the hearing stands adjourned.

[Whereupon, at 5:12 p.m., the subcommittee was adjourned.]

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