August 8, 2014

The Future of the Private Label Securities Market

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The Future of the Private Label Securities Market

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August 8, 2014

David G. Clunie
Executive Secretary
Department of the Treasury

Via http://www.regulations.gov

Re: <u>Public Input on Development of Responsible Private Label Securities (PLS) Market</u>

Mr. Clunie:

The Department of the Treasury has requested input on "the private sector development of a well-functioning, responsible private label securities (PLS) market." The PLS market, like all markets, cycles from greed to fear, from boom to bust. The mortgage market is still in the fear part of the cycle and recent government interventions in it have, undoubtedly, added to that fear. In recent days, there has been a lot of industry pushback against the government's approach, including threats to pull back from various sectors. But the government should not chart its course based on today's news reports. Rather, it should identify fundamentals and stick to them. In particular, its regulatory approach should reflect an attempt to align incentives of market actors with government policies regarding appropriate underwriting and sustainable access to credit. The market will adapt to these constraints. These constraints should then help the market remain healthy throughout the entire business cycle.

I respond to some of your specific questions below.

1. **What is the appropriate role for new issue PLS in the current and future housing finance system? What is the appropriate interaction between the guaranteed and non-guaranteed market segments? Are there particular segments of the mortgage market where PLS can or should be most active and competitive in providing a channel for funding mortgage credit?**

   What is the appropriate role for new issue PLS in the current and future housing finance system?

This question goes way beyond Treasury's portfolio and also touches on those of the FHFA, the FHA and the CFPB, to name a few of the other agencies with jurisdiction over the housing finance system. Nonetheless, it is important that Treasury is framing the issue so broadly because it gets to the 10 Trillion Dollar Question: Who Should Be Providing Mortgage Credit to American Households?

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In recent years, the federal government has insured or guaranteed 80-90% of new residential mortgages. Some believe that the federal government is the only entity that can provide mortgage credit in a stable way and history is arguably on their side. Since the Great Depression, when the Home Owners Loan Corporation, the Federal Housing Administration and Fannie Mae were created, the federal government has had a central role in the housing finance market. Some commentators also believe that there is not enough private capital to replace the government-guaranteed capital in the market in any case.

Others, including me, believe that private capital can, and should, take a bigger role in the provision of residential mortgage finance. There is some question as to how much capacity private capital has, given the size of the residential mortgage market (more than ten trillion dollars). But there is no doubt that it can do more than the measly share of new mortgages that it has been originating in recent years. Scaling back the Fannie/Freddie loan limit is a great way to work private capital back into the market gradually. The long-term health of the American mortgage market is best assured by having private capital assume as much of the credit risk as it can responsibly handle.

This private capital should also be subject to consumer protection regulation to ensure that it is not put to predatory uses. The Consumer Financial Protection Bureau has rules in place to provide that consumer protection. Time will tell whether these rules need to be tweaked, but they are certainly a good start.

Fundamentally, I understand this question to ask — what do we want our mortgage finance to look like for the next eight or nine decades? Our last system lasted for that long, and our next one might too. The issue cannot be decided by empirical means alone. There is an ideological component to it. I believe a broad swath of the populace favors a system in which private capital (albeit heavily-regulated private capital) should be put at risk for a large swath of residential mortgages and the taxpayer should only be on the hook for major liquidity crises and for initiatives that provide homeownership opportunities to low- and moderate-income households. I believe that a broad swath of the electorate would stand behind such a plan whether initiated by the Obama Administration or by Congress.

What is the appropriate interaction between the guaranteed and non-guaranteed market segments?

The government-supported sector of the housing finance market should always be ready to provide liquidity during a financial crisis. This means that the government's housing finance infrastructure should be able to ramp up almost immediately if private credit were to disappear overnight.

The FHA should create a market for first-time homebuyers and low- and moderate-income borrowers. But otherwise, we should look to private capital to price risk and fund mortgages to the extent that it can do so. Round out the system with strong consumer protection regulation from the CFPB, and you have a system that may last through the end of the 21st century.

> *Are there particular segments of the mortgage market where PLS can or should be most active and competitive in providing a channel for funding mortgage credit?*

The government-supported sector of the housing finance market should take responsibility for providing credit to segments of the market that are suffering from some sort of market failure. The government's goal for the PLS market should be that it provides sustainable credit to a wide swath of borrowers who have ready access to private financial institutions. The PLS industry's share of the conforming market should expand over time as it demonstrates its ability to responsibly increase the availability of sustainable credit. This can be achieved by a gradual lowering of the conforming loan limits that are applicable to Fannie and Freddie.

Regulators should monitor the interaction between the Qualified Mortgage (QM) rule and Community Reinvestment Act (CRA) and Fair Lending enforcement. There have been concerns that regulator-sanctioned conservative underwriting might result in comparatively few mortgages being CRA-eligible as well as claims that lenders are violating the Fair Housing Act (FHA). It seems eminently reasonable that lenders not find themselves between a CRA/FHA rock and a QM hard place if they decide to focus on plain vanilla, conservative loans.

That being said, it will be important to continue to monitor whether low- and moderate-income neighborhoods are receiving sufficient amounts of mortgage credit. Given that major lenders are likely to originate non-QM products, this may not be a problem. But we will have to see how the non-QM sector develops before we can know for sure. The federal government may need to take additional steps to ensure that all communities have access to a vibrant mortgage market.

While it is important to make residential credit broadly available, lenders will be doing borrowers no favors if their loans are not sustainable and they end up in default or foreclosure. The federal government should come up with a metric that balances responsible underwriting with access to credit and apply that metric to the QM and Qualified Residential Mortgage (QRM) definitions. Developing a metric is important because there is a lot of pressure to increase access to residential mortgage credit by a range of players — consumer advocates, lenders and politicians to name just a few. But credit that cannot be sustained by homeowners leads to mortgage default and foreclosure. We will be doing new homeowners no favors by letting them take out mortgages with payments that they cannot consistently make, year in and year out.

2. **What are the key obstacles to the growth of the PLS market? How would you address these obstacles? What are the existing market failures? What are necessary conditions for securitizers and investors to return at scale?**

What are the key obstacles to the growth of the PLS market?
Some have recently argued that the federal government has distorted the mortgage market in its pursuit of past wrongdoing and its regulation of behavior going forward. Anecdotal reports such as those about Chase's withdrawal from the FHA market seem to suggest that the answer is yes. Trade publications are rife with stories about fidgety market players who fear relentless prosecution and investigation by a range of government actors, from the Department of Justice to the Consumer Financial Protection Bureau. But it appears to me that commentators might be jumping the gun.

Implicit in their analysis is the view that lending should return in some way to its pre-bust levels. But, in fact, much of the boom lending was unsustainable for many borrowers. Their analysis fails to identify the importance of promoting *sustainable* homeownership and instead relies on one-dimensional metrics like credit denials for those with low credit scores. Until we are confident that borrowers with those scores can sustain homeownership in large numbers, we should not be so quick to bemoan credit constraints for people with a history of losing their homes to foreclosure.

How would you address these obstacles? What are the existing market failures? What are necessary conditions for securitizers and investors to return at scale?
The contours of our new mortgage market are still blurry. The PLS industry does not yet fully understand what part of the mortgage market it can operate in, whether with Qualified Mortgage (QM) or Non-QM products. This is not a market failure. Rather, it reflects a transition period in the market. We will not know if there is a market failure or excessive regulation until this new market matures. There is no reason to believe that there is a market failure at this point in time. It is premature to determine what returning to scale means. The market must evolve on its own for some time before we can determine what "scale" means in the modern mortgage market.

3. **How should new issue PLS support safe and sound market practices?**

The Dodd-Frank regime appears, for now, to be working as intended. It should incentivize mortgage originators to strengthen their compliance practices such as those relating to documentation, recordkeeping and third party due diligence. It should also incentivize securitizers to demand strong representations and warranties, put-back and indemnification provisions.

The PLS industry should work with the government to design metrics to track the mortgage market in real-time. Regulators and academic researchers have been hamstrung by limited and stale data on this fast-moving market. The mortgage market is often driven by the short-term profit-seeking of private actors and by special interests pushing their agendas with the Executive and Legislative Branches. Good data can inform good decision-making that can ensure that the housing finance system is vibrant and provides sustainable credit for households over the long term.

*   *   *

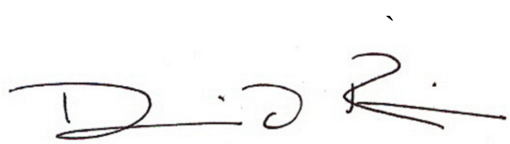
The massive judgments and settlements affecting financial institutions that have been announced in recent months obscure an important aspect of mortgage market regulation. Prosecutors and regulators are punishing wrongdoing by institutions and individuals but regulators are not incentivizing employees of financial institutions to do the right thing. Some of those employees tried to underwrite mortgages properly; some tried to rate securities properly; some tried to follow established due diligence procedures. These employees were overrun by their superiors who were chasing short-term profits for their employers and bigger annual bonuses for themselves. Some of those trying to do the right thing were fired, some retired, some moved on.

How might they view their actions so many years later? Their supervisors likely received large bonuses and promotions and very few of them have been held responsible for their bad acts. Those who tried to do the right thing, on other hand, got harsh words, poor treatment and relatively poor compensation for their troubles.

Just as we want a regulatory regime to disincentivize bad behavior, we should also seek to incentivize good behavior. There is no easy way to do so. But the federal government should consider this as it designs a system that may last for the rest of the 21st century.

(*This comment letter is adapted from previous work of mine that has appeared in a variety of scholarly articles and blog posts, the latter of which are found at* [*REFinblog.com*](REFinblog.com).)

Sincerely,



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