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6 August 2014

Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220
(via Federal eRulemaking Portal)

Re: Public Input on the Development of Responsible Private Label Security (PLS) Market

Ladies and Gentlemen:

1. Thank you for the opportunity to offer input on the private sector development of a well-functioning, responsible market for private-label residential mortgage-backed securities (PLS).[1]

2. ***Appropriate Role for the PLS Market:*** There is a role for PLS in the American housing finance system. PLS should cover some of the area outside the scope of "agency MBS"[2] coverage, providing an alternative source of funding for prime-quality jumbo mortgage

[1] Department of the Treasury, *Public Input on Development of Responsible Private Label Securities (PLS) Market*, 79 Fed. Reg. 36872 (30 Jun 2014) (notice and request for information) (http://www.gpo.gov/fdsys/pkg/FR-2014-06-30/pdf/2014-15355.pdf).

[2] As used herein, the term "agency MBS" refers to the mortgage-backed securities issued or guaranteed by the Government National Mortgage Association ("Ginnie Mae"), the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), or successor entities of any of them that issue MBS backed explicitly or implicitly by a credit guaranty from the United States. In my opinion, Fannie Mae and Freddie Mac should be either converted into or replaced by a single government agency. The agency's employees should be U.S. government employees who are paid on the GS pay scale. The agency's MBS should carry an explicit credit guaranty backed by the "full faith and credit" of the United States. Risk to taxpayers should be managed by using credit risk sharing and credit risk transfer transactions similar to the ones that Fannie Mae and Freddie Mac now use (*i.e.*, buying credit insurance and executing capital market transactions like Fannie Mae's "C-deals" and Freddie Mac's "STACR securities"). The agency should be established under the Treasury Department's Office of Domestic Finance and the head of the agency should report to the Under Secretary for Domestic Finance. HUD is not the right place for the agency because HUD focuses heavily on "affordable" housing, which should ***not*** be part of the new agency's mission. The new agency's mission should be simply to maintain the current efficiency of the conforming loan sector.

loans and for non-prime mortgage loans. Precisely defining the role of PLS, however, requires first defining the appropriate scope of agency MBS.

3. ***Agency MBS Scope:*** Agency MBS programs should cover two types of mortgage loans: (i) loans guaranteed or insured by the FHA or the VA and (ii) conventional,[3] prime-quality, conforming-balance loans. The former should be eligible for any agency MBS and the latter should be eligible for Fannie Mae/Freddie Mac pools.

4. ***Agency MBS – FHA/VA Programs:*** FHA/VA loan programs should continue, because they help to promote home ownership among working-class families with limited savings. Fired in the crucible of the Great Depression and World War II, the FHA/VA programs are among the most successful federal policies ever adopted. They brought America from being a nation of mostly renters to being a nation of mostly homeowners. And, just as important, they did so without pushing the pendulum too far. Before the huge acceleration of "subprime" lending in the early 2000s, the FHA/VA programs had brought the homeownership rate to roughly 65% without pushing homeownership onto households that were not prepared for the associated responsibilities.

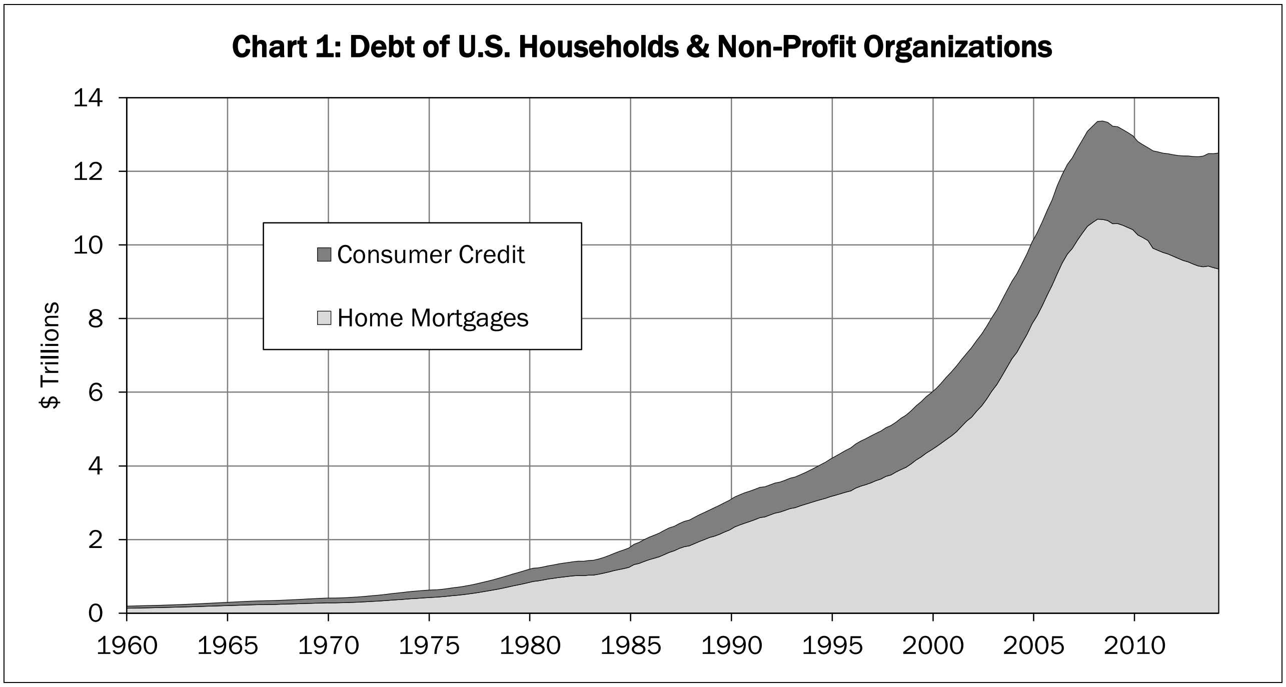
5. The FHA/VA loan programs should have moderately stringent requirements for borrower creditworthiness and should allow for minimal down payments. The purpose of the programs should be to provide a path to homeownership for creditworthy, working-class families that don't have sufficient savings to make the customary 20% down payment. The purpose should not be to extend loans to borrowers with poor credit track records.

6. ***Agency MBS – Conventional Loans:*** The Fannie Mae/Freddie Mac programs for conventional loans have created an ultra-low-cost system for originating, processing, and funding prime-quality, conforming balance loans. Because those loans represent the lion's share of the U.S. mortgage market, the benefits of the agency programs are huge. They have produced incalculable saving for U.S. consumers over the past four decades. Those programs absolutely should be continued, but their standards need to be somewhat tightened. The programs need to revert to their traditional (pre-2000s) role of funding only true, prime-quality loans.

7. Tightening the conventional loan eligibility standards for the agency MBS programs should raise the price of loans that fall outside the standards. That would be a good thing. The financial crisis vividly revealed that the primary mortgage market had

[3] A "conventional" loan is one that is not insured or guaranteed under a federal program.

become overheated by both an erosion of credit standards and shoddy origination practices. As shown on Chart 1, home mortgage debt grew at an unprecedented rate in the early- to mid-2000s. Consumer credit also grew significantly, but the growth was somewhat later. America still needs mortgage and consumer credit to tighten in order to regain stable footing for the long term. Returning to more-traditional mortgage lending standards for agency-eligible, conventional loans is the appropriate path.



Source: Federal Reserve

8. ***Conventional Loan Eligibility for Agency MBS:*** To be eligible for inclusion in a Fannie Mae/Freddie Mac MBS pool, a conventional loan should have to have all the following attributes:

- Conforming balance
- Original borrower equity of at least 20% (*i.e.*, original CLTV ≤ 80%)
- Front-end ratio of no more than 28%
- Back-end ratio of no more than 36%
- Reserves of at least three months
- Full documentation of borrower income and assets
- No major derogatory in past two years
- No minor derogatory in past year (except for extenuating circumstances)
- No bankruptcy in past seven years

- First-lien
- No simultaneous second- or higher-lien loans
- Owner-occupied, primary residence
- Qualifies as a "qualified residential mortgage" under 15 U.S.C. § 78*o*-11(e)(4)

9. Any of the following attributes should disqualify a conventional loan from inclusion in a Fannie Mae/Freddie Mac pool:

   - Original borrower equity less than 20%, *even with* primary mortgage insurance
   - Front-end ratio above 28%
   - Back-end ratio above 36%
   - Reserves less than three months
   - Less than full documentation of borrower income or assets
   - Any major derogatory in past two years
   - Any minor derogatory in past year (except for extenuating circumstances)
   - Any bankruptcy in past seven years
   - Second or higher lien status
   - Any simultaneous second- or higher-lien loan
   - Non-owner occupied property or non-primary residence
   - Not a "qualified residential mortgage" under 15 U.S.C. § 78*o*-11(e)(4)

10. The eligibility standard proposed above is tighter than the historical standards of the GSEs. However, the proposed standard would serve to target *EXACTLY* the kind of loans that *SHOULD BE* in agency MBS pools. There doesn't appear to be a compelling policy reason to use agency MBS pools to support loans on vacation homes and investment properties. Likewise, encouraging homeowners to use their homes as piggy-banks (through second mortgage loans) is exactly the wrong thing to do. Also, after the demise of several mortgage insurance companies during the financial crisis, the GSEs (and ultimately the taxpayers) should not take loans with LTVs greater than 80% simply on the basis of private-sector mortgage insurance.

11. The conforming loan limits should be restored to their levels in 2007:

    - $417,000 for a one-family home
    - $533,850 for a two-family home
    - $645,300 for a three-family home
    - $801,950 for a four-family home

12. There should be no separate loan limits for "high cost areas" but special limits for Alaska and Hawaii are appropriate. The limits should be adjusted annually – both up and down – based on the consumer price index.

13. ***PLS – Target Loans:*** The grist for the PLS mill should be conventional mortgage loans that do not qualify for inclusion in Fannie Mae/Freddie Mac pools, either because they exceed the conforming loan limit or because they possess other disqualifying attributes. The tighter standards proposed above for agency-eligible conventional loans would leave a sufficient quantity of non-agency-eligible loans to fuel the PLS process. However, as in the past, PLS will be just one of several funding sources for non-conforming loans. Some will remain on financial institution sheets and others will be securitized as PLS.

14. As in the past, the PLS market will likely develop subsectors. One would be for prime-quality, jumbo loans – those that exceed the conforming loan limit but that otherwise would qualify for including in a Fannie Mae/Freddie Mac pool. Other subsectors would develop for non-prime-quality loans – those that fail to qualify for inclusion in a Fannie Mae/Freddie Mac pool for reasons other than loan size. In all likelihood, separate subsectors would emerge for near-prime-quality loans and for those of weaker quality (*i.e.*, sub-prime).

15. ***Obstacles to the Revival of the PLS Market:*** Today, the most important obstacle to the revival of the PLS market is the excessively high conforming loan limit, which allows loans up to $625,000 in so-called "high-cost" areas. The loan limits proposed in ¶ 11 are high enough to include loans on roughly 90% of the homes in the U.S. but stop short of subsidizing housing for the wealthy (which has never been a legitimate policy objective).

16. A second obstacle to the revival of the PLS market is complexity. Certain investors got burned by the proliferation of fancy bells and whistles in the PLS that they bought. In particular, some experienced significant disappointment because of features that allowed subordinate tranches to receive cash flows even after it was clear that their deal's underlying pool was performing badly. Standardization of deal structures and tranche types is a possible strategy for reducing complexity.

17. A third obstacle relates to the strength of representations and warranties in PLS deals. Following the financial crisis, issuers have attempted to narrow the scope of the representations and warranties that they make concerning the attributes of the mortgage loans backing a deal. Any erosion of the representations and warranties will rightly make investors wary of buying PLS.

18. Representations and warranties in PLS transactions should cover all "manufacturing defects" for the life of the loans. On the other hand, representations and warranties should not cover credit deterioration on non-defective loans. Representations and warranties should survive for the entire life of a PLS transaction. A seller's obligation to repurchase a defective loan (*i.e.*, a loan that breaches a representation or warranty) should not be subject to any condition of causation or materiality.

19. Additional obstacles are (i) aligning issuer and originator interests with investor interest and (ii) improving disclosure materials.

20. ***PLS Support of Safe and Sound Market Practices:*** PLS are the wrong tools for promoting safe and sound practices in the primary mortgage market. Direct regulation of mortgage origination and mortgage servicing would work much better. For example, if policymakers determine that no mortgage loan should be originated with a loan-to-value ratio above a given threshold, they should simply make it illegal to originate such loans. Likewise, if policymakers determine that no mortgage loan should be originated unless the lender has documented the borrower's income and assets, then they should simply make it illegal to originate any mortgage loan without such documentation. To make sure that such measures actually affect behavior, the penalties for violations should be meaningful and should increase for repeat offenses.

21. Direct regulation of the terms of residential mortgage loans was quite common in the past. For example, a 1950 study from the National Bureau of Economic Research described limitations on the amounts loanable on specific properties as follows:

> Other provisions of state laws place an upper limit on the amount that may be loaned against a property of given appraised value. This is termed the maximum loan-to-value ratio. As indicated above, insured and guaranteed loans are generally exempt from this and other restrictive rules, but most states specifically limit loan-to-value ratios on other types of mortgages. The maximum is usually set at 50 or 66⅔ percent of the appraised value of the property, generally the latter; it is never below 50 and if above 66⅔ percent the law generally requires that the lending agency conform to certain provisions regarding maximum term and amortization of the loan balance or that it accumulate special loss reserves against the contracts, or both. For example, the New Jersey law permits loans up to 75 percent of appraised value if fully amortized, and if the company carries as a reserve the amount by which the loan exceeds 66⅔ percent of the appraised value of the property. Similarly, the Wisconsin law, which limits a company to 50 percent loans, permits loans up to 60 percent of the property's appraised value if provision is made for complete amortization within fifteen years. Leasehold loans may be limited to a smaller percentage and there may be a requirement, though not in all states, that the loan be reduced to an amount not above a specified percentage of the appraised value of the security if the value of the security falls.

> In view of the dependence placed by state laws on property appraisals, it is natural that they should set standards of one sort or another that are intended to give validity to appraisements. For example, the Ohio law requires a written evaluation under oath by two real estate owners resident in the same county or local district where a property is located or by a "qualified land appraiser." The New York law, on the other hand, merely states that no mortgage loan may be made by an insurer "except after an appraisal made by an appraiser for the purpose of such investment."[4]

22. By contrast, the main issues for promoting safety and soundness in the *SECONDARY* mortgage market (*i.e.*, the PLS market) are (i) reducing complexity, (ii) standardization of tranche types and deal structures, (iii) aligning issuer and originator interests with investor interests, and (iv) making disclosure materials useful and meaningful. The FDIC-imposed limit on the number of credit tranches included in a deal[5] is a step in the right direction, but more is needed to reduce complexity to an acceptable level. Another possible measure for reducing complexity and promoting standardization would be to impose a relatively simple "standard" deal structure by statute or regulation. There is some precedent for doing so: the Trust Indenture Act mandates specific indenture terms in all SEC-registered debt offerings. The argument that mandatory standardization would hurt the U.S. economy by stifling "financial innovation" is a canard. Financial innovation is hardly an absolute good. It gave the U.S. financial system many of the products that helped bring about the financial crisis. A good number of those products provided the means for major institutions to subvert safety-and-soundness regulations by taking-on more risk than they could handle. A little less financial innovation going forward might be a good thing.[6]

23. In the area of aligning issuer and investor interests, the regulatory proposal to require credit risk retention is directionally appropriate, but its latest version needs to be made tougher.[7]

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[4] Saulnier, R.J., *Urban Mortgage Lending by Life Insurance Companies*, at 22-23, National Bureau of Economic Research (1950) (http://papers.nber.org/books/saul50-1) (footnotes omitted).

[5] 12 C.F.R. § 360.6(b)(ii)(A) (2014) (http://www.gpo.gov/fdsys/pkg/CFR-2014-title12-vol5/pdf/CFR-2014-title12-vol5-sec360-6.pdf).

[6] To be fair, some financial innovation has been very good for America. Notable examples include money market funds, TIPS, IRA accounts, and 401(k) plans. Of course, the creation of the original Ginnie Mae MBS was another example of good financial innovation.

[7] Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Securities & Exchange Commission, and Department of Housing & Urban Development, *Credit Risk Retention*, 78 Fed. Reg. 57928 (20 Sep 2013) (proposed rule) (http://www.gpo.gov/fdsys/pkg/FR-2013-09-20/pdf/2013-21677.pdf). I submitted a comment letter on the

24. Fixing disclosure practices may be the toughest problem. The PLS industry has a tradition of producing obnoxiously long and unhelpful disclosure materials. There is so much repetition and boilerplate that the important content gets lost (assuming it was included at all). The SEC's proposed update to Regulation AB is a step in the right direction.[8] However, even there, big issues sometimes get lost in the minutiae. For example, the proposal places heavy emphasis on the role of loan-level data, but it stops short of calling for prospectuses to include summary tables that would show the effect of "risk layering." Addressing the issue would be relatively easy.[9] In that connection, regulators should be mindful that detailed loan-level disclosure is not a panacea. Although it is great for the largest investors who have the systems for processing it, other investors don't have those systems. Disclosure should work for those investors as well.

25. In addition, issuers and underwriters should be required to publicly disclose (and file with the SEC) all information that they supply to credit rating agencies in connection with a public offering of PLS. Such a requirement would simply give effect to the practical reality that information used in determining a credit rating is material to investors. The SEC disclosure system ostensibly requires issuers to disclose (and file) all material information. To date, issuers have not publicly disclosed all the information that they supply to credit rating agencies, arguing that such information is not material to investors and, therefore, is not required to be disclosed (or filed). That argument is simply fatuous.

26. Requiring issuers and underwriters to publicly disclose all information that they give to credit rating agencies in PLS offerings would have a beneficial side effect: it would enable the rating agencies to do unsolicited ratings of PLS more easily. The SEC has recognized that unsolicited ratings are part of the solution to the problem of "rating

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proposal in which I recommended several changes that I believe would improve the final rule (http://www.fdic.gov/regulations/laws/federal/2013/2013-credit_risk_retention-c_11.pdf).

[8] Securities & Exchange Commission, *Asset-Backed Securities*, Release Nos. 33-9117, 34-61858, 75 Fed. Reg. 23328 (3 May 2010) (proposed rule) (http://www.gpo.gov/fdsys/pkg/FR-2010-05-03/pdf/2010-8282.pdf); Securities & Exchange Commission, *Re-Proposal of Shelf Eligibility Conditions for Asset-Backed Securities*, Release Nos. 33-9244, 34-64968, 76 Fed. Reg. 47948 (5 Aug 2011) (http://www.gpo.gov/fdsys/pkg/FR-2011-08-05/pdf/2011-19300.pdf).

[9] See Adelson, M., *ABS/MBS Disclosure Update*, Nomura Securities fixed income research (29 Apr 2004) (http://www.securitization.net/pdf/content/Nomura-ABS-MBS_29Apr04.pdf).

shopping" and amended Rule 17g-5 to encourage unsolicited ratings.[10] However, the rule has not worked as intended. The relevant portions could be repealed if issuers and underwriters were required to publicly disclose all information that they supply to rating agencies in PLS offerings.

27. ***Costs and Benefits of Investor Protection:*** Left to themselves, markets do not produce an optimal level of investor protection. That is the essential underlying reason for the federal securities laws and state "blue sky" laws. The societal interest in having a well-functioning securities market to support the process of capital formation justifies governmental intervention to implement investor protection. The U.S. capital markets remain the envy of the world, and rightly so. As a general matter, the benefits of investor protection initiatives have consistently been worth their costs. There have been only isolated instances, such as the Sarbanes-Oxley Act[11] and the Dodd-Frank Act,[12] where the cost-benefit balance has been seriously questioned.

28. The experience of the financial crisis demonstrates that there would be value in having at least one transaction participant who champions investors' interests in each securitization deal. Even before the financial crisis, certain episodes in the securitization market, such as the infamous NCFE fraud, revealed the value of such a role.[13] It can be achieved either by introducing a new transaction participant (a collateral manager) or by imposing a new duty on an existing participant (making the trustee a fiduciary of investors). However, the collateral manager option may be the better one because it would likely be more effective at avoiding conflicts of interest problems.[14]

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[10] 17 C.F.R. § 240.17g-5 (2014) (http://www.gpo.gov/fdsys/pkg/CFR-2014-title17-vol4/pdf/CFR-2014-title17-vol4-sec240-17g-5.pdf); Securities and Exchange Commission, *Re-Proposed Rules for Nationally Recognized Statistical Rating Organizations*, 74 Fed. Reg. 6485, 6505-06 (9 Feb 2009) (http://www.gpo.gov/fdsys/pkg/FR-2009-02-09/pdf/E9-2514.pdf); Securities and Exchange Commission, Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 63832 63844 (4 Dec 2009) (http://www.gpo.gov/fdsys/pkg/FR-2009-12-04/pdf/E9-28496.pdf).

[11] Sarbanes-Oxley Act of 2002, Pub. Law No. 107-204, 116 Stat. 745 (2002) (http://www.gpo.gov/fdsys/pkg/PLAW-107publ204/pdf/PLAW-107publ204.pdf)

[12] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law No. 111-203, 124 Stat. 1376 (2010) (http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf).

[13] Department of Justice, *Seven National Century Financial Enterprises Executives Indicted In $3 Billion Securities Fraud Scheme*, press release (22 May 2006) (http://www.justice.gov/opa/pr/2006/May/06_crm_316.html)

[14] The 1990 changes to the Trust Indenture Act (TIA) introduced the current system in which the trustee under a bond indenture is allowed to have conflict of interest prior to a default on the subject bonds.

29. ***Role of Private Market Participants in Removing Obstacles:*** Don't count on the private market to be able to remove the main obstacles to the revival of the PLS market. Trade groups like the American Securitization Forum (ASF) and the Structured Finance Industry Group (SFIG) have been ineffective in reviving the PLS market despite years of trying. Such organizations attempt to achieve consensus among issuers, investors, and intermediaries. However, their differences are sometimes irreconcilable. This produces gridlock that makes results unachievable.

30. ***Role of Government in Removing Obstacles:*** Regulatory intervention could be effective in removing obstacles. It could lower the balance limits for conforming loans (as described in ¶ 11) and it can implement the other measures described above (¶¶ 22-26).

31. ***Pricing of PLS***: The market should be left to price the next generation of PLS in the same manner that it has always priced PLS – based on its assessment of the prepayment and credit risks embedded in the securities. There is little reason to doubt that underwriters of the next generation of PLS will supply prospective investors with computational materials that display "fair value" pricing under numerous scenarios. That will focus the pricing dialog where it ought to be: on the plausible range of performance outcomes based on historical performance and the ongoing evolution of the mortgage market. The fact that the market so badly underestimated the risk in PLS the period before the financial crisis suggests that the appropriate range of pricing scenarios should include ones that are quite adverse. In the end, the most senior tranches of PLS deals (*i.e.*, the ones that embody the least credit risk) will likely price slightly farther behind agency MBS than did their pre-crisis counterparts.

32. ***Investor Demand for PLS:*** There can be little doubt that, at the right price, there will be strong investor demand for PLS. What should not be expected is that investors will be suckers willing to accept risk without an incremental expected return. Ideally there would be enough investor demand so that PLS would serve as the funding source for a significant portion of – but not all – non-conforming loans. PLS should compete with institutions' balance sheets as a source of funding.

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Trust Indenture Reform Act of 1990 § 408, Pub. Law No. 101-550, 104 Stat. 2713 (1990) (amending Trust Indenture Act § 310(b), 15 U.S.C. § 77jjj(b)) (http://www.gpo.gov/fdsys/pkg/STATUTE-104/pdf/STATUTE-104-Pg2713.pdf). Although the governing documents for PLS generally are not qualified under the TIA, the TIA's conflict-of-interest rules are instructive. In retrospect, based on the experience of PLS through the financial crisis, the 1990 TIA conflict-of-interest changes might not have been such a good idea.

33. This letter represents my personal views and not the views of any organization or company with which I am (or have been) associated.

34. Please feel free to contact me if you would like to discuss the recommendations in this letter. Thank you again for the opportunity to comment on the private sector development of a well-functioning, responsible market for PLS.

Sincerely,

Mark Adelson

Mark Adelson