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

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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.

Edward DeMarco
Acting Director, Federal Housing Finance Agency

On August 25, 2009 President Obama designated Edward J. DeMarco the Acting Director of the Federal Housing Finance Agency (FHFA), the regulator of Fannie Mae, Freddie Mac and the 12 Federal Home Loan Banks effective September 1, 2009. Mr. DeMarco was appointed Chief Operating Officer and Senior Deputy Director for Housing Mission and Goals for FHFA in 2008 after enactment of the Housing and Economic Recovery Act of 2008, the legislation that established FHFA. Mr. DeMarco joined the Office of Federal Housing Enterprise Oversight (OFHEO), a predecessor agency to FHFA, in October 2006 as its Chief Operating Officer and Deputy Director. He came to OFHEO from the Social Security Administration (SSA) where, as Assistant Deputy Commissioner for Policy, he led SSA's policy, research, and statistics functions. Before joining SSA in 2003, Mr. DeMarco was Director of the Office of Financial Institutions Policy at the U.S. Department of the Treasury where he oversaw analyses of public policy issues involving government sponsored enterprises and other financial institutions. Prior to his ten-year tenure at the Treasury Department, he worked at the U.S. General Accounting Office for seven years. Mr. DeMarco received a Ph.D. in Economics from the University of Maryland and a B.A. in Economics from the University of Notre Dame.