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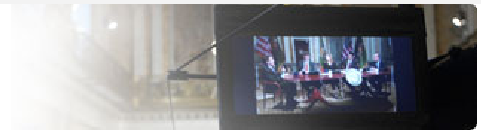

Remarks by Counselor to the Secretary for Housing Finance Policy Dr. Michael Stegman before a Bipartisan Policy Center Panel “Reigniting the Private Label Mortgage-backed Securities Market”

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WASHINGTON - From the beginning of the Administration's efforts to achieve comprehensive housing finance reform, we have envisioned a healthy residential mortgage market as consisting of four distinct channels: an agency channel with private capital in a first-loss position and a catastrophic government guarantee; an FHA channel with a more direct government guarantee to serve low- and moderate-income families; whole loans held on bank and private sector balance sheets, and a non-agency fully private securitization channel. A diverse housing finance system featuring multiple execution channels would promotes competition, market efficiency and consumer choice.

Given our deep policy interest in putting private capital back at the center of the housing finance system, Treasury launched an initiative to facilitate the development of market standards and practices necessary for a well-functioning, sustainable PLS market. In June, Secretary Lew announced a request for public comment on this subject. We received many responses from a mix of industry groups, investors, issuers, and service providers and received informal feedback from many more. We held a roundtable with institutional investors, and are meeting with issuers, trustees, and due diligence firms to evaluate the most effective methods of ensuring investor protections, implementing necessary market reforms, and enforcing standards.

The title of this morning's panel is "Reigniting the Private Label Mortgage-Backed Securities Market." And given its role in the run-up to the recent financial crisis, some have asked why this Administration would want to see this market come back. This is a serious question that deserves a serious answer; so before we get into a discussion of what it will take to bring it back, we should take a few minutes to make the best possible case for why a robust non-agency, non-government guaranteed residential mortgage securitization market alongside the other three channels mentioned is in the best interest of families, credit markets, and the economy.

Historically, securitization has played a valuable role in housing finance. By allowing interest rate and credit risks to be allocated efficiently among investors with varying risk appetites, it expanded access to credit for many credit-qualified Americans. Before 2002, approximately 50 percent of first-lien PLS issuance was collateralized by loans too large to qualify for a government guarantee, commonly referred to as the jumbo market. Another 10 percent was collateralized by loans to borrowers with strong credit histories who were unable to provide the necessary income documentation required to qualify for a loan that could be purchased or guaranteed by a GSE or could be insured by FHA, generally because they were either self-employed, worked on commissions, or had irregular incomes. The remainder was composed of weaker credit-quality, subprime borrowers.

These proportions changed significantly during the run-up to the housing bubble, as market discipline and underwriting standards broke down and investors sought securities that offered higher returns. Since the crisis, we have made significant progress toward remedying many of these problems, notably by moving forward with implementation of key parts of the Dodd-Frank Act. The Consumer Financial Protection Bureau (CFPB) issued Ability-to-Repay and Qualified Mortgage standards, requiring lenders to verify a borrower's ability to repay a loan when extending mortgage credit. The risk retention rule, also mandated by Dodd-Frank, when finalized, will require securitizers to retain a minimum of 5 percent of credit risk or "skin in the game," of the mortgage loans they securitize that do not meet the Qualified Residential Mortgage definition.

Additionally, we have made headway toward improving transparency in the PLS market. The Securities and Exchange Commission (SEC) has now finalized Regulation AB II, governing disclosures on asset-backed securitizations, improving transparency for investors. The last remaining piece of the puzzle is putting in place standards and enforcement mechanisms for representations and warranties to help protect investors in residential mortgage-backed securities (MBS) so that they have the confidence to return to the market at scale. This would also require more clearly defining issuer responsibilities.

In short, we believe that if done in a safe and sound way with proper controls and standards in place, non-agency securitization has the potential to expand access to credit and offer more efficient pricing to creditworthy borrowers while providing pricing discipline to the market as a whole. It would also reduce the concentration of mortgage credit risk within the banking system and in other government-supported channels, which is another strong policy imperative.

While Treasury's PLS initiative and the Administration's policy goal are to encourage a robust PLS securitization market that will provide another liquid source of financing for a more diverse borrower base as part of comprehensive housing finance reform, virtually all post-crisis PLS issuances to date have been collateralized by jumbo loans to borrowers of pristine credit quality. Correcting the existing imbalance and enhancing the market's vibrancy is what our panel is all about.

Lastly, I want to focus on Treasury's efforts to help market participants address critical impediments to restarting a healthy non-government guaranteed securitization sector.

At a high level, we see two big stumbling blocks to this market's recovery. The first is that with respect to loans that are not eligible for purchase and guarantees by government-supported channels, current market conditions and the economics of securitization favor whole loan trading and retention in portfolio rather than pooling and securitizing. The second stumbling block is largely structural in nature, leading to a lack of trust among institutional investors and consequent unwillingness to buy the most senior tranches, which typically comprise ninety percent or more of the entire capital structure of PLS issues.

Because financial market conditions will not always favor balance sheet funding of long-term fixed-rate mortgages, we believe that now is the time to address the structural flaws holding back the PLS market so that when conditions are more favorable to securitization, there will be a healthy appetite for product at the most competitive possible prices to consumers. This is why Treasury's initiative is aimed at helping market participants address structural impediments, many of which take the form of "chicken and the egg paradoxes." Let me mention just a few of these.

Issuers frequently complain about the government's expansive footprint, starving the PLS market of product, with the resulting illiquidity hampering both investor demand and issuer participation. At the same time, the Federal Housing Finance Agency has said that it will not consider reducing GSE conforming loan limits unless and until it sees evidence that private capital is ready to step in at sufficient scale so as not to adversely impact the current health of the market. We agree that absent structural reforms, materially lowering GSE loan limits would at best, raise mortgage rates, and at worst, reduce access to credit.

Another chicken and the egg problem is a reluctance of some issuers to allocate firm resources to address necessary PLS structural reforms when the economics of mortgage funding favor other forms of execution. This type of short-sighted resource allocation will lengthen the time it takes to address critical investor confidence issues--insufficiency of representation and warranty enforcement mechanisms, opaqueness in servicing practices, and lack of transparency in data and disclosures-- and inevitably delay the restart of the PLS market.

Another issue is how credit rating agencies would evaluate more diverse mortgage pools than have been brought to the post-crisis PLS market. This has the same kind of "which comes first" problem as the others. Rating agencies will not rate mortgage pools until they receive the actual loan tape, while sponsors will not originate or aggregate more diverse loans for securitization without some prior indication of the subordination levels required to merit AAA rating of the senior bonds. This in turn would inform what sort of execution they could achieve in the secondary market. The resulting stalemate means more diverse pools will not be brought to market.

Treasury believes that by increasing clarity around loss projections and subordination requirements for more diverse pools of collateral, credit rating agencies can stimulate a constructive market dialogue and foster greater confidence in the credit rating process. We plan to work with all of the credit rating agencies in the coming weeks to better understand their methodology for modeling loss expectations for a broader sample of MBS pools. We will provide more details about how mortgage originators and aggregators can get greater clarity into available secondary market execution options soon.

Over the next hour, this panel will discuss potential ways of addressing these and other obstacles to the return of the PLS market, and I look forward to hearing from my panel colleagues.

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