U.S. DEPARTMENT OF THE TREASURY

Press Center

Remarks by Deputy Assistant Secretary Monique Rollins on Reforming the Private Label Securitization Market at the Asset Backed Securities (ABS) Vegas Conference

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LAS VEGAS - For most of its history, private label securitization (PLS) has served as a valuable part of the housing finance market. It helped expand access to credit for many qualified Americans, who did not meet the underwriting criteria or conforming loan limits of Fannie Mae or Freddie Mac or qualify for Federal Housing Administration (FHA) insurance. However, the 2008 financial crisis exposed huge structural deficiencies in PLS that led to tremendous losses and severely damaged the trust of market participants. The pre-crisis PLS market was rife with conflicts of interest, inadequate investor protections, overreliance on credit ratings, contractual enforcement failures and a lack of transparency. We therefore believe that, while the PLS market can provide a channel for mortgage financing that is responsible and not reliant on a taxpayer-backed guarantee, its return must happen in a reformed and sustainable way. A reformed PLS market complements the Administration's efforts to support the housing recovery on numerous fronts by improving access to credit and helping homeowners. While we do not see the PLS channel as a total panacea, it is one of a number of channels that can responsibly improve access to credit and strengthen the housing recovery.

In 2014, Secretary Lew announced a Treasury-led effort to help catalyze the private label residential mortgage-backed securities (RMBS) market through engagement with market participants and other stakeholders, which we will refer to as the PLS Initiative. Treasury published a Request for Information in the Federal Register seeking public input on the challenges facing the market. We facilitated a credit rating agency exercise to provide greater transparency into post-crisis rating methodologies for residential mortgage loans. And, observing a collective action problem, we believed Treasury was well positioned to facilitate a dialogue among market participants whose trust had been badly damaged. So, we brought together institutional investors, issuers, servicers, ratings agencies, due diligence firms and other key stakeholders and provided an open and neutral forum for engagement. As we have heard from these stakeholders firsthand over the past year and a half, in order to rebuild investor confidence, establish a resilient, sustainable transaction architecture, and bring back significant capital to the non-agency housing market in a responsible way, significant structural reforms are needed.

Early on in the process, Initiative participants explored the potential for a so-called benchmark transaction, which could have become a de facto standard that other market participants could replicate in order to grow issuance volumes and create liquidity. But given the complexity of the issues at hand and the lack of favorable market conditions, their focus shifted toward addressing a set of specific structural reforms, and here they have made significant progress.

I will now review some highlights from these discussions. Please keep in mind that this summary does not represent consensus recommendations from the group but rather reflects ideas that were raised by participants and explored extensively within the Initiative. I would also like to note that in facilitating discussions, Treasury did not and does not seek advice or recommendations for any federal government policy, decision or activity.

Initiative Summary

The group focused on three main topic areas with the objective of identifying potential improvements to the structural weaknesses of the PLS market: 1) the concept of a "Deal Agent"; 2) servicing activities and oversight; and 3) origination representations and warranties.

Deal Agent

The investor-proposed addition of a new "Deal Agent" transaction party was the reform idea that was discussed most extensively, with many investor participants indicating that it would be key to enhancing their confidence in the PLS market. For those of you who would like more detail on a proposed Deal Agent framework, I encourage you to take a look at the "Proposed Deal Agent Agreement Key Principles" published this morning. This document is not endorsed by Treasury or all PLS Initiative participants, but the fact that this substantive reform proposal has emerged is an encouraging sign that these conversations among various market participants are making meaningful progress.

Intended to improve upon the current structure of special purpose vehicles, the inclusion of a Deal Agent would allow a "thinking" entity to make decisions in both routine circumstances, and importantly, in response to unforeseen events. In this regard, participants who favor this Deal Agent framework believe that the Deal Agent should act in a fiduciary-like capacity subject to duties of care and loyalty. This would mean that the entity is expected to act in the best interests of the trust, have no conflicts of interest with other transaction parties, and refrain from placing the interests of one class of bondholders over another, doing away with the concept of a controlling class of investors.

In defining the scope of a Deal Agent's responsibilities to the securitization trust, participants identified several key categories, such as the review of representations and warranties, enforcement of representations and warranty breaches, servicer oversight (including servicing transfer, if necessary), the reconciliation of cash flows going into and out of the trust, and bondholder communication. Discussions also included important considerations related to a Deal Agent role: indemnification by the trust, caps on liability, the potential for liability insurance, and how to develop a viable compensation framework.

Participants also identified a number of practical challenges. While investors felt it was imperative that a Deal Agent agreement should include a fiduciary duty, others felt that the standard of care should be defined in a more circumscribed way. Some noted that there was substantial overlap between the proposed responsibilities of a Deal Agent and those of existing transaction parties. Though some rating agency participants have commented publicly that the inclusion of a Deal Agent could potentially be credit positive, a number of participants wondered whether ratings agencies would "give credit" to transactions with a Deal Agent by requiring lower credit enhancement. Several participants also raised important questions about how oversight by a potential Deal Agent would work in practice.

While many agreed that the inclusion of a Deal Agent could potentially add value to a transaction by providing enhanced transparency, oversight, and enforcement, some participants expressed concern about justifying the additional fee and indemnification expenses to the trust, particularly for transactions with pristine collateral. Some suggested that this framework could be better suited and make more economic sense for transactions with riskier loan attributes, or reperforming or nonperforming loans, and that it could potentially facilitate access to credit for borrowers who are underserved by other financing channels.

Servicing

In discussing structural reforms related to both servicing and underwriting, participants focused on creating a framework in which errors could be caught early and fixed quickly, with an emphasis on compliance with all applicable laws and regulations. The investor participants in the Initiative expressed a strong interest in strengthening minimum servicing standards by requiring servicers to maximize the value of collateral to the trust as a whole, as well as improving the alignment of interests between servicers and the trust (and thereby investors). Alternative compensation models were also discussed, with many investor participants advocating for a model that would better match the timing of revenues with expenses. An oversight mechanism based on defined measures, or key performance indicators, which could facilitate servicer termination and transfer in the event of nonperformance or underperformance was also examined.

Several potential ways to improve alignment of interests were raised, including trust ownership of mortgage servicing rights, restrictions on securitizations of loans with second liens, checks and balances pertaining to affiliates, and automatic stop-advance triggers for principal and interest. Some participants advocated for increased standardization and transparency for net present value (NPV) models and decisions pertaining to loss mitigation, recoverability, and reimbursement of advances. Others emphasized the need for further industry work on improving the processes related to cash flow reconciliation between primary and master servicers. Investors also expressed a desire to be represented at bank and servicer settlement negotiations and advocated for a prohibition against the use of trust modifications to fulfill settlements.

Representations and Warranties

Many Initiative participants emphasized that another key to enhancing investor confidence in PLS is ensuring the enforcement of contractual terms for all transaction parties. Contractual provisions related to representations, warranties and repurchase enforcement were among the biggest concerns for investors and issuers alike and therefore constituted a key area of focus for Initiative participants. Given the ongoing work to propose an industry standard for representations and warranties in other fora, notably through the Structured Finance Industry Group's RMBS 3.0 Initiative, participants directed their discussion toward improving the disclosure and repurchase enforcement mechanism. Some investor and rating agency participants expressed an interest in improving disclosures through requiring that deviations from a standard slate of representations and warranties be clearly highlighted in transaction documents.

Conclusion

As Secretary Lew said in his 2014 announcement of the PLS Initiative, "we believe that an expanded role for the PLS channel can responsibly broaden access to mortgage credit for qualified borrowers who are not being served today, while helping protect taxpayers by shrinking the government's footprint in the housing market." Initiative participants have taken an important step toward understanding how structural reforms could help the PLS channel expand responsibly. We are now at a transition point for the PLS Initiative, where some market participants can start moving from a principles-level discussion to contractual negotiations.

The reform ideas that I've summarized today do not represent one uniform path forward for the PLS market. We recognize that there is no "one-size-fits-all" solution to complex legacy issues, particularly given the differences in the business models of, and regulations applicable to, different market participants. Issuance volumes also remain low, in no small part due to the relatively weak economic incentive for securitization of non-agency mortgage pools in the current market environment for many issuers. But it's clear that many of you see multiple ways for a reformed PLS market to meaningfully return and we have been impressed by the considerable time and resources that you have devoted to our Initiative and other reform efforts. We encourage you to build on this momentum and continue to engage directly with each other, with industry associations, think tanks and other stakeholders.

In closing, Treasury remains committed to seeing a reformed PLS market emerge, broadening access to mortgage credit for qualified borrowers who are not being served today. We look forward to our continued engagement with market participants, policymakers and the public.

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