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Ms. Mary John Miller
Undersecretary for Domestic Finance
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Public Input on Development of Responsible Private Label Securities Market
79 FR 36872-73 (June 30, 2014)
http://www.gpo.gov/fdsys/pkg/FR-2014-06-30/pdf/2014-15355.pdf

Dear Ms. Miller,

The American Bankers Association appreciates this opportunity to comment on the Treasury Department's request for consultation on development of a functioning private label securities (PLS) market. ABA represents banks of all sizes and charters and is the voice for our nation's $14 trillion banking industry and its two million employees.

ABA appreciates the Administration's interest in this subject, and particularly the efforts undertaken in recent months to bring stakeholders together to discuss these issues in the context of legislative efforts to reform the secondary mortgage market. We view this request for comment as an extension of those efforts. While ultimately the responsibility for reform will require legislation, the Administration will play an important role both in facilitating that reform effort and in ensuring that necessary action short of legislative reform is effectively administered. We hope that our comments below are helpful to both of those efforts.

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?***

§ Comments could address: the role of the government in the mortgage market; access to mortgage credit; cost of mortgage finance; capital available for this type of investment; the source of loans for securitization; product and structure innovation; types of mortgage products; and borrower characteristics.

ABA believes that ultimately the role of the government in housing finance should be dramatically reduced from its current level. A private market for the vast majority of housing finance should be fostered and encouraged with an ultimate goal of a much smaller governmental role focused primarily on ensuring market stability, access to the capital markets for all originators, and as a safety valve in the event of market failure. More significant government involvement may be necessary and desirable for the creation of affordable rental housing and to assist first-time borrowers or others who may not readily qualify for conventional financing. A well-regulated private market should be the desired financing source for the bulk of borrowers whose income and credit rating qualify them for conventional financing. ABA strongly endorses the continued federal guarantee of existing GSE debt and securities to ensure stability as the process moves forward.

Because of the trauma suffered by the financial markets and the borrowers they served during the recent financial crisis, it will be necessary to move toward a substantially private market in a measured and well-considered fashion. A transition period taking a number of years likely will be necessary.

ABA has not endorsed a specific secondary market structure going forward, but instead has considered the mechanisms to be employed to reduce governmental involvement and to foster private sector financing – and to ensure that such financing can involve private sector banks of all sizes. Possible structures for a transition vehicle (and potential end point) include a cooperative structure owned by the financing entities (for issuing securities) and a well-controlled public utility (for providing a limited, fully priced and paid for guarantee for that segment of the market requiring it). Pending legislation in the Senate (S. 1217, passed by the Senate Banking Committee by a vote of 13 to 9 on May 15, 2014) would utilize such an approach, and ABA remains supportive of the bill's further consideration by the full Senate. Whatever structure is chosen will require significant control and direction of guarantee fees, mission, and investor returns so as to keep it confined to a controlled mission and to ensure that the role of government itself does not impede ultimate success in aiding the return of a private secondary mortgage market.

Additionally, rather than developing a single "silver bullet" solution to housing finance, it may be desirable to develop a multiplicity of sources which aid in the reestablishment of a private market. Thus, in addition to the creation of a successor entity or entities to the GSEs, policy makers may want to consider the creation of a well-regulated covered bond market, as well as enhancements to the Federal Home Loan Banks which better help them meet their mission of providing advances to private market portfolio lenders. Multiple sources of liquidity for private market lenders (and especially portfolio lenders in the examples cited) will lead to a more diverse and ultimately safer housing financing system.

The primary mechanism for reducing government involvement (and for compensating the government for the current ongoing support) is through adjustments to the guarantee fees (G fees) paid to the GSEs (or their successor(s)). ABA believes that the current G fees are too low – that the compensation being paid for what amounts to full government backing is simply not priced correctly. Raising the G fee can do much to encourage development of the private market and to begin to repay the government for its current support. By "dialing up" the G fees in an orderly and well-detailed manner, eventually the private market will find itself in a position where it is better able to compete with the GSEs for business. With a high enough G fee, the private market will be able to price for risk in a fashion that allows for safe and sound investment and lending at a rate that is comparable (and perhaps eventually better) than the rate charged by the GSEs. In the meantime, the increased rates for the G fees will help to offset losses and assist in the repayment of the government's investment in Fannie Mae and Freddie Mac. This approach also allows for flexibility in the setting of guarantee fees, thereby ensuring a safety valve for housing finance in the event of private market disruptions.

While ABA maintains that increased G fees are an important mechanism for reducing barriers to private capital reentry into the secondary market, and are desirable as a means for better compensating the federal government for risks being borne by the taxpayer, we also recognize that G fees are only a part of the puzzle and must be adjusted in conjunction with other policy changes. Absent those other policy changes, increasing G fees may do little to spur the return of private capital and may, in fact, make further reforms to the secondary market more difficult to attain.

While the GSEs have, in recent quarters, improved the cash flow, the reality is that they continue to operate without any real capital, and any downturn could cause them to again require infusion of funds from the U.S. Treasury. Further, under the existing conservatorship agreement, any "profits" made by the GSEs are swept to the Treasury, not channeled toward a guarantee fund to protect taxpayers, used to rebuild capital, or even to retire the existing debt owed to the Treasury. All funds going to Treasury are essentially a dividend with the government's "investment" remaining in place.

As long as all "profits" from the GSEs are being swept to the U.S. Treasury without building a guarantee fund, a capital base for the GSEs (or their successor(s)) or retiring the existing debt owed to the Treasury, increasing the G fees can, in fact, make reform more difficult, because these "profits" are a stream of income to the federal government which will be lost under reform efforts.

While increased G fees do provide more income to the Treasury and in the broadest sense do provide compensation for the risk being borne by the taxpayers, that compensation is unfocused so long as it goes into general Treasury funds. Ideally, increased G fees would be directed to a new guarantee fund or to the capital base for the GSEs or successor guarantors, or at least more directly focused on the government's role in the secondary market.

Additionally, given the precarious state of the U.S. economy generally, and the housing market in particular, increasing the G fees at this time may further inhibit affordability and harm the market.

The regulator and conservator of the GSEs, the Federal Housing Finance Agency (FHFA), has sought comment on whether guarantee fees should be raised. ABA does not recommend to the FHFA that G fees should be raised at this time but that increases should be undertaken as part of a holistic approach that has as its goal the return of private capital to the secondary market, the shrinkage of the government's role in that market, and more adequate compensation paid to the government for the risks it takes on. All of this must be considered in the context of the current and expected economic conditions, and must take into consideration any expected legislative actions (or inactions) in the foreseeable future.

The other key mechanism to transition to a private market will be the setting of more reasonable loan limits for GSE purchases. The current maximum loan limit of $625,500 in high cost areas and $417,000 in all other regions is dramatically higher than necessary for the purchase of a moderately priced home, especially in light of housing price declines nationwide. While some high-cost areas persist (and a full recovery of the housing market will entail a hoped-for increase in home values), the conforming loan limits for much of the nation can be reduced further. This will assist the development of a private market for loans outside of the conforming loan limits as a step to a more fully private market for all loans.

Underwriting will also be an important mechanism, but given the significant new underwriting requirements required by the banking regulators and by the Dodd/Frank Act, it would seem that the most important role played by the government in this area for the foreseeable future is to ensure that uniform underwriting requirements are followed by all market participants. The recently finalized Ability to Repay/Qualified Mortgage rulemaking from the Consumer Financial Protection Bureau (CFPB) should lead to a broad category of conservatively underwritten loans (those qualifying for the QM safe harbor) which will not likely trigger resort to a federal guarantee. Some loans outside the safe harbor may require some level of federal guarantee to ensure liquidity for that segment of the market, but the market for such loans is still in its formative state and will likely require time to develop. If, over time, QM loans outside of the safe harbor (those with a "rebuttable presumption of compliance") prove to be well-performing, a private market may develop for these loans.

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

   § Comments could address: structural, operational, economic, regulatory, loan level data, other disclosures, and legal challenges.

   § Challenges may include methods of investor protections; desire for standardization; secondary market liquidity and size; underwriting standards; origination volumes; servicing practices; credit ratings; and risks arising from borrower default.

ABA believes that the growth of the PLS market is constrained by a number of factors, including an uncertain and ever changing and expanding regulatory environment, a still less than robust economy, and an ongoing inability to compete with government backed financing for mortgages.

Since 2008 virtually the entire federal regulatory regime for mortgages has been rewritten and vastly expanded. A new regulator, the Consumer Financial Protection Bureau (CFPB) was created, imposing new requirements, liabilities and restrictions on lenders, servicers and potential investors in mortgages, and expanding and rewriting existing regulations. This process continues. Additionally, a number of other regulatory changes and additions have been, or are in the process of being imposed by other regulatory agencies. Among the CFPB imposed rules are the aforementioned Ability to Repay/QM rule, and significant new servicing rules. Final rules imposed by other regulators which affect mortgage markets include implementation of Basel III. The punitive treatment of mortgage servicing assets has the potential to dramatically shift mortgage servicing out of the banking industry, which will affect PLS market dynamics. Still pending rules include credit risk retention (QRM) and implementation of a rewrite of RESPA/TILA, the Basel securitization framework capital rules, and a number of other regulatory changes required by the Dodd/Frank Act.

While the U.S. economy has improved in recent years, growth remains slow and home sales weak in many areas of the nation. Though GDP growth rebounded in the second quarter, it fell in the first quarter. We have only seen GDP fall during an expansion three times in the past 50 years, two of the three have been in recent years. Housing continues its improvement based on price recovery, but existing and new home sales have fallen below their levels of a year ago. The aforementioned new rules required under the Dodd/Frank Act, particularly the Ability to Repay/QM rules, have made it more difficult for borrowers to qualify for loans, further inhibiting lending and investor interest in the mortgage sector.

Finally, as discussed in our response to Question 1 above, guarantee fees paid to the GSEs are lower than they should be to fully compensate the federal government for the risk being borne. Conforming loan limits for GSE-backed mortgages remain at higher than necessary levels, and exceptions to the QM rules for the GSEs and other government-backed loans, such as FHA and VA loans, all tilt the regulatory and pricing advantage to the government. In combination, these advantages make investment in the mortgage sector by the private market less attractive at best.

Despite these constraints, ABA is not entirely pessimistic about prospects for evolution of a PLS market. New TILA regulations tended to reduce credit availability, especially for non-QM loans, and the lack of PLS outlets for such loans has further reduced credit availability in this segment. Nevertheless, targeted non-QM loans have been made by lenders with portfolio capacity since the beginning of 2014, and evidence suggests that somewhat greater numbers of non-QM loans are being put into portfolio as lenders conduct ongoing risk and market assessments. This lending is creating a pool of quality non-QM loans that will constitute performance benchmarks necessary for investors’ eventual decisions to purchase PLS assets, as well as a building block for the PLS securitization process. It is also likely that as portfolio investments in non-QM loans increase, lenders will become more likely to sell some seasoned non-QM loans into an emerging PLS market to manage balance sheet risk. Therefore, one of the precursors for a successful PLS market may be beginning to fall into place.

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

§ Comments could address: underwriting standards; transparency and disclosure requirements; borrower protections; alignment of interests; and regulatory oversight.

The new rules cited above are having a dramatic impact on loan underwriting. The loans being made today are far more conservatively underwritten and safer than at almost any time in living memory. This, combined with the aforementioned investor wariness of the mortgage sector has created an environment where only extremely high quality loans will be of interest to securitizers and investors. One response to the financial crisis was to decry the “originate to sell” model of lending and securitization. The improvements to underwriting mandated by the Ability to Repay/QM rules, and the “skin in the game” requirements of the still to be finalized risk retention/QRM rules, have led to a securitization market that is far safer and more sound than prior to the financial crisis.

4. ***What are the costs and benefits of various methods of investor protection? In particular, please address the costs and benefits of requiring the trustee to have a fiduciary duty to investors or requiring an independent collateral manager to oversee issuances.***

§ Comments could address: willingness of parties to accept a fiduciary duty; capital requirements and sufficiency; fiduciary duty as a means of addressing conflicts of interest; and alternative methods of investor protection.

ABA's Corporate Trust Committee continues to review the issue of imposing a fiduciary duty on trustees in PLS transactions. As an initial matter, we note that imposing such a duty would be a significant change to the current practices of this industry. We will respond more fully in the near term.

5. ***What is the appropriate or necessary role for private industry participants to address the factors cited in your answer to Question #2? What can private market participants undertake either as part of industry groups or independently?***

§ Comments could address: methods of achieving agreement around establishment of industry-wide standards; or development and adoption of a limited number of structural options from which securitizers can choose.

ABA remains committed to working with the Administration, regulators, Congress and other industry and consumer groups to advocate for needed changes to policy and practice. Some of these changes, such as changes to regulations to ensure that credit can continue to flow to qualified borrowers, can be undertaken without legislation. Others, such as increases to guarantee fees paid to the GSEs, can be taken without legislation, but must be undertaken in a holistic fashion which may require other changes which do require legislation. As markets evolve and investors, lenders and borrowers adapt to new requirements, we will also continue to engage in advocating for necessary changes to reflect new market realities. Ultimately, however, legislative change will be required to rebalance the role played by government in the mortgage markets. We stand ready to work with all stakeholders toward that end.

6. ***What is the appropriate or necessary role for government in addressing the key factors cited in your answer to Question #2? What actions could government agencies take? Are there actions that require legislation?***

§ Comments could address: suggested role in facilitating resolution of issues impeding the return of an active PLS market; actions that are required from government agencies; and actions that require legislation.

As noted above, while ABA remains committed to working with all stakeholders, ultimately legislation will be required to rebalance the government's role in housing finance. In the meantime, regulators must monitor the impact of new regulation on the market and engage with industry groups to ensure that credit is not unnecessarily denied to qualified borrowers. Administration officials must remain mindful of economic changes and evolutions in the marketplace by investors, lenders and borrowers and act accordingly as necessary to address both foreseen and unforeseen developments quickly. Among the more important initiates underway are ongoing changes to representations and warranties related to secondary market loan sales. It is demonstrably clear that past experiences with crisis period loan buybacks have caused originators to impose a protective underwriting overlay that has reduced credit availability. It is essential to maintain progress toward clearer and reliable standards for representations and warranties, including the ability to cure for issues discovered by quality control processes now in place.

7. ***What are the current pricing characteristics of PLS issuance (both on a standalone basis and relative to other mortgage finance channels)? How might the pricing characteristics change should key challenges be addressed? What is the current and potential demand from investors should key challenges be addressed?***

   § Comments could address: amount and sources of demand for new issue PLS; cost of funding and capital; appropriate parties or processes to address the current pricing of PLS issuance; pricing in other mortgage financing channels.

PLS execution tends to price higher than either GSE-backed or portfolio loans. Improvements in execution through, for example, a single securitization mechanism, could help to improve pricing of PLS execution, but until and unless the many advantages to GSE-backed loans are moderated or removed, a PLS market will be difficult to reestablish.

8. ***Why have we seen strong issuance and investor demand for other types of asset-backed securitizations (e.g., securitizations of commercial real estate, leveraged loans, and auto loans) but not residential mortgages? Do these or other asset classes offer insights that can help inform the development of market practices and standards in the new issue PLS market?***

   § Comments could address: relevant terms, standards, and covenants; key differences in underlying assets; comparisons of structural features; documentation; alignment of interests; relative value, relative risks, and required returns; and examples of other asset classes' emergence and growth over time.

Other asset classes did not face the traumatic collapse experienced in the mortgage markets during the financial crisis. The fundamental principles that for years had underpinned the mortgage markets were called into question during that crisis, as some borrowers chose to walk away from mortgages, while still making payments on other types of debt such as auto loans and credit cards. This is in part a result of the bubble that developed in real estate and in part due to other changes in consumer behavior that social scientists may study and debate for years to come. Nevertheless, the fact remains that the mortgage markets suffered a failure unlike that experienced by other market sectors. Exacerbating this have been policy choices made or considered in reaction to the crisis, including the forced buybacks of loans for even minor violations, the consideration of the use of eminent domain to restructure mortgages, and an ongoing, although largely unrealized, call for write downs of mortgage principal. Such actions, whether implemented or not, erode lender and investor confidence and willingness to engage in the marketplace.

9. ***Is there any additional information regarding the PLS market not already addressed that you would like to provide?***

As mentioned in response to question 4 above, ABA's Corporate Trust Committee will provide further comments in the coming days on the question of costs and benefits of investor protections.

Conclusion

The American Bankers Association appreciates this opportunity to provide input on the important questions surrounding reestablishment of a viable private label securities market. We stand ready to work with you and will be pleased to provide additional input or answer any questions you may have. Please do not hesitate to contact Joseph Pigg, Senior Vice President and Sr. Counsel, at 202-663-5480 or JPigg@aba.com for further information or discussion.

Sincerely,

Robert R. Davis