THE NEED FOR NATIONAL MORTGAGE SERVICING STANDARDS

MAY 12, 2011

Anthony Sanders
Distinguished Professor of Real Estate Finance, George Mason University
Senior Scholar, Mercatus Center

Senate Committee on Banking, Housing and Urban Affairs
Subcommittee on Housing, Transportation and Community Development

Chairman Menendez, Ranking Member DeMint, and distinguished members of the Subcommittee, thank you for inviting me to testify today. I have been asked to offer opinions on "The Need for National Mortgage Servicing Standards"

The recent crash of the housing market and the rise of unemployment led to a historic surge in serious delinquencies and requests for loan modifications, short sales, and related transactions. As a result, the residential mortgage servicing industry was overwhelmed. Going forward, it is helpful to recommend changes to both servicing and securitization industries so that they can avoid problems going forward as we attempt to revive the securitization market.

Servicing Standards

During a December 1, 2010 hearing, Federal Reserve Board Governor Daniel Tarullo stated that "it seems reasonable at least to consider whether a national set of standards for

mortgage servicers may be warranted." Although the Government Accounting Office (GAO) has released a report to Congress recommending creation of servicing standards,[1] I agree with the sentiment but disagree with the process.

Pooling and Servicing Agreements

There already exists pooling and servicing agreements (PSAs). The PSA is a legal document that contains the responsibilities and rights of the servicer, the trustee, and other parties concerning a pool of securitized mortgage loans. If the securitization is public, the documents must be filed with the Securities and Exchange Commission.

It has been suggested that PSAs be uniform and I would agree that greater uniformity among PSAs would reduce investor uncertainty. However, rather than having it regulated by the Federal government, uniformity of PSAs would seem to be a natural evolution demanded by investors in the marketplace.

Broader Servicing Guidelines and Standards

In December, Christopher Whalen, Nouriel Roubini and others wrote a letter to U.S. financial regulators regarding national loan servicing standards.[2] I am one of the signers of the letter, but not because I wanted to have national loan servicing standards created by the Federal government. Rather, I wanted to open a discussion for consideration by servicing companies. Many of the items that were discussed were plausible recommendations.

The private sector is able to adopt guidelines and standards for loan servicing. For example, the Mortgage Bankers Association (MBA) created a task force of key MBA members to examine and issue recommendations for the future of residential mortgage servicing. While

---

[1] Government Accountability Office, "Mortgage Foreclosures: Documentation Problems Reveal Need for Ongoing Regulatory Oversight," GAO-11-433, May 2011.

[2] "Open Letter to U.S. Regulators Regarding National Loan Servicing Standards," Christopher Whalen, et. al, December 21, 2010, http://www.rcwhalen.com/pdf/SecuritizationStandardsLetter_final_122110.pdf.

it is be tempting to have the Federal government regulate loan servicing, it will be more effective to have an industry group such as MBA provide guidance.

One of the items recommended in the Whalen letter to regulators was:

> *As part of your duties under Section 941 of the Dodd-Frank Act, your agencies must develop new standards for the secondary market in mortgage loans. These standards must promote a sustainable securitization market and, in particular, maintain additional "skin in the game" for sellers of loans so the excesses and abuses of the past are not repeated. As part of this effort, you will be defining the criteria for the highest quality residential mortgages, those which do not need risk retention. This new definition for what constitutes a qualified residential mortgage should be the gold standard in all areas of mortgage origination, securitization packaging and servicing, and disclosure.*[3]

While I agree with the signers that standards could be advantageous to investors and consumers, we need to be careful about the implementation of standards and rules, such as risk retention, which is also an important part of addressing this issue. Ultimately, servicing inadequacies are part of the problem of origination risk, which I address below.

Risk Retention and Servicing

Dodd-Frank requires that securitizers retain at least five percent of the risk in all loans that do not qualify as a Qualified Residential Mortgage (QRM)[4] and are sold into the securitization market. In theory, five percent risk retention would lead securitizers to be more careful in the loan origination, underwriting and servicing process.

---

[3] *Ibid.*

[4] A qualified residential mortgage (QRM) is one with a 80% loan to value, full documentation, and more traditional underwriting standards. Generally includes the 30 year fixed-rate mortgage and excludes exotic mortgages such as interest-only mortgages.

To be sure, five percent risk retention would be the simplest approach to implement in order to encourage improved loan origination, underwriting and servicing. Unfortunately, risk retention also appears to be the least useful approach.

First, the house price collapse resulted in house price declines that far exceeded five percent; for example, Las Vegas fell 56 percent from peak to trough [see Figure 1 for the collapse of housing prices].[5]

Second, risk retention does not directly address origination risk or servicing risk.[6] Representations and warrants ("reps and warranties") that are found in Mortgage Loan Purchase Agreements (MLPA) and related documents are supposed to directly address origination risk. The avalanche of loan repurchase requests in the aftermath of the housing collapse makes reps and warranties less viable for non-agency mortgage-backed securities.

Third, the Federal Housing Administration (FHA), Fannie Mae and Freddie Mac are exempt from risk retention rules. Exempting these players in the mortgage market defeats the spirit of risk retention since a loan originator will be tempted to sell to or be insured by Fannie Mae, Freddie Mac and the FHA rather than keep the retained risk. All financial entities should be subject to risk retention or none at all.

Fourth, given Reg AB (Dodd-Frank 942) and the anticipated transparency of the asset-backed securities markets, the retention rule implies that Qualified Institutional Buyers (QIBs) are not sophisticated enough to understand origination risks and need to be protected beyond greater transparency. QIBs (or "sophisticated investors") such as Fannie Mae, Freddie Mac, PIMCO and others do not require the additional security of five percent

---

5 Free exchange, "Recovery comes to Las Vegas," The Economist, January 26, 2010, http://www.economist.com/blogs/freeexchange/2010/01/recovery_comes_las_vegas

6 Origination risk refers to the risk of breaches of underwriting standards, misrepresentations, fraud, poor data quality and legal breaches.

risk retention since they perform substantial due diligence and analysis before purchasing securities. Furthermore, they would have been expected to understand the servicing process and PSAs.

Moreover, it is unclear how risk retention will be implemented (e.g., vertical versus horizontal versus "L" cuts) and if it is even effective in reducing origination risk.

There are more effective alternatives to risk retention: transparency and improved reps and warranties via an origination certificate.

Greater Transparency

One solution to origination risk is to provide greater transparency to investors. Greater transparency would permit more accurate pricing. Greater transparency potentially reduces the asymmetric information between securitizers and investors.

There has already been a movement in the industry towards greater transparency. Prospectuses and Prospectus Supplements for both agency and non-agency mortgage-backed securities provide detailed breakdowns of the underlying loans in terms of critical risk measures such as loan-to-value ratio, loan type, credit score, etc. In 2006, Freddie Mac took loan transparency to a new level by providing a file of loan level information.[7] The non-agency market (as well as the FHA) could provide similar loan level disclosure.

I would prefer that the securitizers provide transparency themselves rather than be forced through regulation. Some investors may prefer having less information disclosed which should result in a higher expected yield compared to fully-disclosed loan information. Investors should retain the right to choose how much information that they want disclosed by securitizers.

---

[7] See data reports provided by Freddie Mac and available at: http://www.freddiemac.com/mbs/html/data_files_5bd.html

But additional loan disclosure is just one prong to providing a better alternative to retained risk. The other is to enact an "origination certificate" approach to reducing securitization risk.

Origination Certificate

Even though securitizers could release great loan-level information, the market would still be concerned that the information is inaccurate. Furthermore, transparency doesn't address servicing problems. There should be mechanisms to insure that the disclosed information is actually correct and that proper servicing is followed. Andrew Davidson and I proposed a "securitization certificate" in our paper "Securitization after the fall."[8] In the paper, we write:

> *We propose a "securitization certificate" which would travel with the loan and would be accompanied by appropriate assurances of financial responsibility. The certificate would replace representations and warranties, which travel through the chain of buyers and sellers and are often unenforced or weakened by the successive loan transfers. The certificate would also serve to protect borrowers from fraudulent origination practices.*

The securitization or origination certificate approach has the potential to be effective because it directly addresses origination risk and contains a fraud penalty.[9] The origination certificate would travel with the loan and would verify that the loan was originated in accordance with law, that the underwriting data was accurate, and that the loan met all required underwriting requirements. This certificate would be backed by a guarantee from the originating firm or other financially responsible firm and would travel with the loan over its life. The seller must provide a means of demonstrating financial responsibility,

[8] Andrew Davidson and Anthony B. Sanders, "Securitization after the fall," Second Annual UCI Mid-Winter Symposium on Urban Research, "Housing after the Fall: Reassessing the Future of the American Dream," February 2009, http://merage.uci.edu/ResearchAndCenters/CRE/Resources/Documents/Davidson-Sanders.pdf.

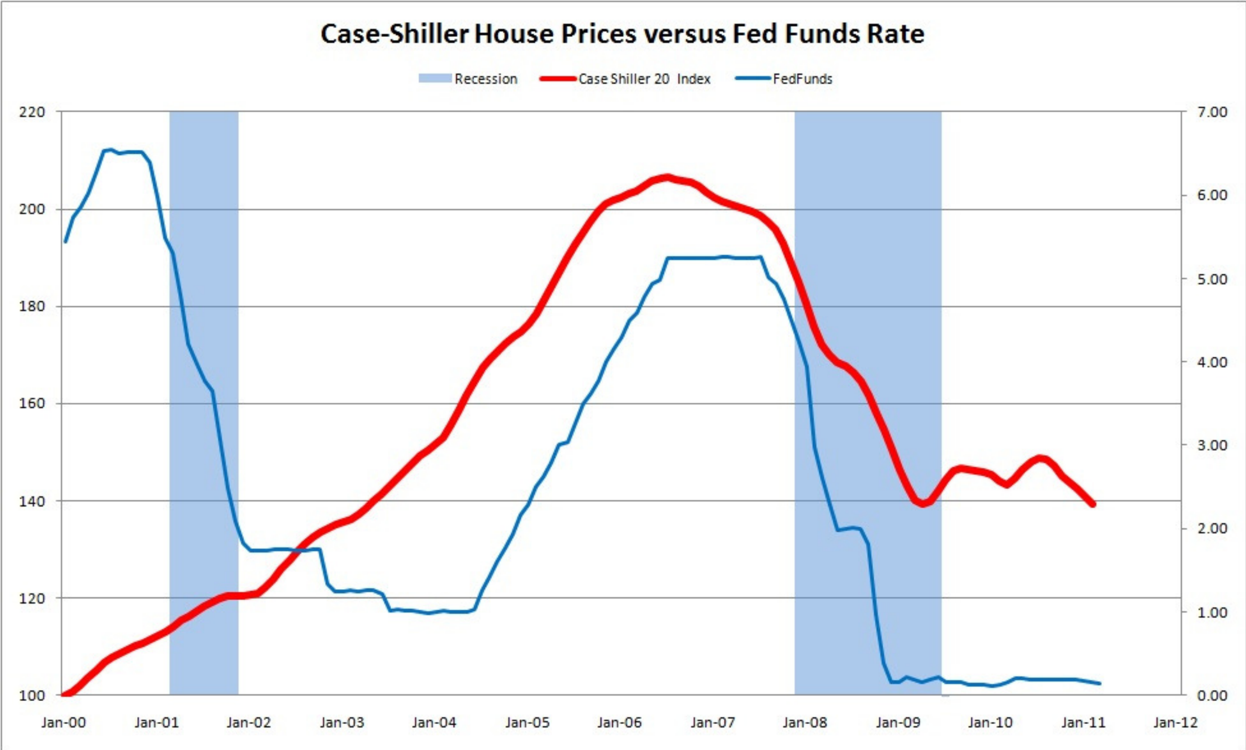
9 Andrew Davidson and Eknath Belbase, "Origination Risk in the Mortgage Securitization Process: An Analysis of Alternate Policies," The Pipeline, Andrew Davidson & Co., 2010.

either via capital or insurance, for the loans to be put into a securitization. There should be a penalty for violations of reps and warrants beyond repurchase obligations and tracking of violations of reps and warrants available to all investors. Furthermore, there could a penalty for violations of the servicing standard adopted by the securitizer.

It is my opinion that risk retention is ineffective at best in solving underwriting and servicing issues. Increased transparency and loan specific origination certification is a more effective way of preventing future problems. And they are best designed and implemented by the private sector and not the Federal government.

Thank you again for the opportunity to testify. I look forward to your questions.

Figure 1. Case-Shiller House Prices versus Fed Funds Rate



Anthony B. Sanders
Senior Scholar, Financial Markets Working Group, Mercatus Center at George Mason University
Distinguished Professor of Real Estate Finance, George Mason University

Anthony B. Sanders is a Senior Scholar at the Mercatus Center at George Mason University. He is also Professor of Finance in the School of Management at George Mason University where he holds the title of Distinguished Professor of Real Estate Finance. He has previously taught at University of Chicago (Graduate School of Business), University of Texas at Austin (McCombs School of Business) and The Ohio State University (Fisher College of Business). In addition, he served as Director and Head of Asset-backed and Mortgage-backed Securities Research at Deutsche Bank in New York City.

His research and teaching focuses on financial institutions and capital markets with particular emphasis on real estate finance and investment. He has published articles in Journal of Finance, Journal of Financial and Quantitative Analysis, Journal of Business, Journal of Financial Services Research, Journal of Housing Economics and other journals. Professor Sanders has received 6 teaching awards and 3 research awards. He serves as Associate Editor for several leading journals. Recently, he has given presentations to the European Central Bank in Frankfurt, Exane BNP Paribas in Paris and Geneva and the Bank of Japan on the subject of the housing bubble and commercial real estate in the U.S. and the mortgage market. He has given other presentations in Chile, Japan, China, Poland, England and Mexico in recent years. Professor Sanders has testified in the U.S. Senate and U.S. House of Representatives on the U.S. real estate asset and debt markets. Also, he was an invited speaker to the FTC on the subject of predatory lending.

Dr. Sanders earned his PhD and MA from the University of Georgia.