

Q&A *with* Treasury's David G. Nason

BY
ROBERT
STOWE
ENGLAND

Assistant Treasury Secretary for Financial Institutions David G. Nason has held that position at Treasury since his confirmation by the Senate in June 2007. His responsibilities have included an evaluation of the legislative and regulatory oversight of the government-sponsored enterprises (GSEs) as well as the Federal Home Loan Bank System.

Nason heads up the Treasury Department staff's internal review of the U.S. financial regulatory system—an initiative launched by Treasury Secretary Henry M. Paulson in April 2007. The Treasury Department review produced a regulatory blueprint for broad reform of the financial system just as this article was being published.

Nason has also served as a key adviser to the Treasury

secretary in his capacity as chair of the President's Working Group on Financial Markets. Nason came to Treasury in 2005 from the Securities and Exchange Commission (SEC). While at the SEC, he served as counsel to SEC Commissioner Paul S. Atkins and was a primary adviser on capital raising and corporate governance issues. Prior to joining the SEC, Nason was an attorney at Covington & Burling LLP in Washington, D.C., where he focused on securities offerings, mergers and acquisitions and federal tax planning.

He resides in Virginia with his wife, two daughters and a newborn son. *Mortgage Banking* caught up with Nason at his Treasury office in March, just as he was overseeing the finishing touches on the regulatory blueprint for broad reform of the financial markets.

This high-ranking Treasury official talks about the financial system reform proposal just released by Treasury, as well as GSE reform and HOPE NOW results.

Q: *In the last year or so, issues surrounding housing and mortgage finance have become central to the entire economic outlook for the nation. What are your thoughts on that?*

A: [It] is certainly the case that housing represents the single biggest risk to our economy. [And] it's the biggest drag on our economy right now. We are still very confident that our economy is strong and resilient. We're still predicting growth. It's quite clear we're experience a slowdown. Energy costs are a factor. Turbulence in the credit market is another factor. [Yet] there are lots of positive things to point to in our economy. Our unemployment is low. Our exports are high. Our corporate balance sheets are strong.

Q: *What about the challenges facing our financial institutions?*

A: Our financial institutions moved into this period extremely well-capitalized, and we have to be thankful for that. [And the financial institutions continue to be] well-capitalized. But I'll go with what Secretary [Paulson] has said in that regard. If there are opportunities for financial institutions to strengthen their balance sheets, they should be doing so.

Q: *Your congressional testimony on GSE reform has focused on areas of regulatory vulnerability. You have indicated, for example, that the regulators should have new review authority of the investment portfolios over the GSEs as well as the Federal Home Loan Banks—bringing their powers more in line with the regulation of traditional banking regulation. Elaborate on this position a bit more.*

A: I'll start with the way we look at the GSE issue. From where we are today, from a regulatory perspective, you have a regulator in the [Office of Federal Housing Enterprise Oversight (OFHEO)] that is ill-equipped to deal with its regulated institutions. OFHEO does not have the same powers that a traditional bank regulator has. That's indisputable. They don't have the ability to raise capital on a temporary basis, like a bank regulator has. They don't have the ability to raise minimum capital requirements by regulation, like a bank regulator has. They don't have the ability to put an entity into receivership, like a bank regulator has. So, they are ill-equipped to deal with their large, complex, regulated institutions. And that's not something that's really debatable.

One of the elements of the GSEs that has garnered a lot of attention from the Treasury, from the Fed, over the course of a period of years—not just this administration—is the retained portfolio the GSEs have. Remember, the GSEs have two businesses. There's securitization business [on one side. On the other side there's the] investment portfolio business, [which] provides some liquidity to the markets—but I think it's safe to say it is driven more by investment returns to the GSEs. The connection between the investment portfolio and the GSEs' mission is less clear than on the securitization side. And that's

“We are still very confident that our economy is strong and resilient. We're still predicting growth.”

a long-held view and a bipartisan view, at least in Treasury.

The reason I focus on the retained portfolio in my testimony is just the consequences of it. If you step back and think about it, those two organizations hold \$1.4 trillion of assets in their retained portfolios in the form of mortgages, whole mortgages, GSE mortgage-backed securities [MBS]—each other's and their own—and private-label mortgage-backed securities. [Their] capital as a cushion for the risk is [somewhere between] \$30 [billion] and \$40 billion. So that's a significant amount of leverage. They are more highly leveraged than our other financial institutions by a great degree.

There are two types of risk in the mortgage portfolio. There's credit risk and interest-rate risk. Both of those are magnified [by high leverage] in this environment [of turmoil in the credit markets]. So, now more than ever, we have a need for a stronger GSE regulator to take a look at these.

Q: *The House has passed GSE reform legislation while the Senate has yet to act. What key provisions are you looking for in GSE reform?*

A: You know, the Senate had a hearing [at which I testified], and there seemed to be pretty clear support among the members of the Banking Committee [for comprehensive GSE reform]. They [had another hearing in March with industry people]. Hopefully, that's an indication that we're going to see some movement on the legislation. [Editor's note: This interview was conducted March 5.]

Q: *Do you expect the legislation to spell out the guidance on capital requirements, or is it likely to leave it up to OFHEO or whatever entity becomes the consolidated regulator of the GSEs and Federal Home Loans Banks?*

A: There are a variety of different legislative proposals for GSE reform in Congress. But let's focus on what the administration supported on the House side. Our goal is that something like that will be the starting point on the Senate side. For capital, all the legislation is clear that this regulator would have greater authority in terms of setting and administering the capital requirements on the GSEs.

Q: *So, if the regulator decided the GSEs and Federal Home Loan Banks needed to have more capital, they could require it?*

A: There are two components to capital authority for a bank regulator. The first is a minimum capital requirement. That's what you have to have all the time. And then the second is [the authority to require] increases for temporary circumstances for particular conditions. Right now, OFHEO can't raise its minimum capital because it's in the statute and [cannot be determined] by rule [by OFHEO]. So the legislation would give them the authority to do that by rule. And it would also give them a clear authority to raise capital for temporary periods, like right now.

On the portfolio side, there are a variety of different approaches in terms of dealing with what authority the regulator would have over the retained portfolio. The administration was supportive of the legislation that came out of the House committee, which we thought gave the regulator appropriate authority over the portfolio. That was weakened when it was on the House floor. We hope to strengthen that on the Senate side. We think that there's a legislative framework that can work to everyone's benefit, and the difference among all the folks who have been involved with this to date over a long

period of time is not as wide as it was before Secretary Paulson got here.

Q: *So the regulator could set a cap on the size of the GSEs' portfolios?*

A: Under the legislation from the House committee, [the size of the investment portfolio] could grow or be reduced. [The proposed legislation] basically told the regulator to evaluate that portfolio in compliance with safe and sound operations of the GSEs and the public mission of the GSEs. It gives specific criteria with which to evaluate those by. We've been very clear to say that it is not a clear *per se* cap on the portfolio. The mortgage market is getting larger over time, so it's certainly feasible the portfolio would get larger over time.

Q: *What do you think the impact will be of temporary higher loans limits at Freddie, Fannie and the Federal Housing Administration [FHA]?*

A: I would just like to sit back for a second and say the loan limits should [as a matter of principle] be increased only in conjunction with comprehensive GSE reform. And that wasn't the case. I just wanted to make clear that is still our view. [Higher loan limits] should only be a temporary increase, because greatly expanding the conforming loan limits is at odds with the GSEs' affordable-housing mission. That's also a uniform bipartisan position in the [Treasury] Department.

It is certainly true that in the secondary market for mortgages, the market that is performing best is the one that has a GSE guarantee. So our expectation, as part of the legislation, is that a GSE guarantee on jumbo loans would foster more secondary market activity in that market. The actual price and costs remain to be seen.

Q: *Would not the higher loan limits expand the potential origination capabilities of both portfolio lenders and mortgage bankers and brokers who have business models based on 100-percent securitization of originations?*

A: What it does, the way Fannie and Freddie operate, [is they] set up a series of criteria that a broker or an originator would have on their screen to figure out if you qualify for a GSE loan, and that broker or originator would have a new mechanism in which to provide a GSE-securitized loan. It would also free up portfolio lenders' balance sheets. Now they have an avenue for securitization that they didn't have [before].

Q: *What impact do you see from higher loan limits for the GSEs on the non-agency secondary market?*

A: There has been, is now, and will continue to be a very large private-sector mortgage-backed securities market in the jumbo space. We're starting to see signs that's coming back. It's not functioning as it was. There's every expectation that it will, because many jumbo loans that are originated and securitized are excellent credit.

Q: *A number of observers have noted that once the loan limits are raised, it's going to be hard to lower them again. Do you agree?*

A: I know that's an issue that's been raised. The legislation is set to expire. We're going to hold the legislators at their word that it will expire.

Q: *If you get the GSE reform, higher conforming loan limits might be part of that?*

A: We'll be confronted with the choice of whether or not that's something we would like to do. It seems clear that the GSEs were created for a public purpose. A significant piece of that public purpose is affordable housing. It's an OFHEO public-policy question to determine whether or not securitizing loans to the \$700,000 level is consistent with that affordable-housing goal.

Q: *Some people think that by giving Fannie and Freddie the authority to raise the conforming loan limit temporarily, it might actually delay the recovery of the private-label jumbo market. What's your view?*

A: I think that's probably a fair criticism. I mean, you want to have secondary market activity happen as quickly as possible. It is good for the economy that the secondary market be functioning better than it currently is. I have a lot of faith in capital markets. I think we're going to have a strong secondary market for jumbo mortgage-backed securities on the private-label side.

Q: *The Treasury Department's press conference on HOPE NOW and other initiatives, such as FHASecure, have been fairly upbeat about the potential for these programs. How are these programs doing?*

A: We're obviously monitoring very closely the data that's coming in. [And] we have seen success. For example, in the FHASecure program, which provides a workable solution for a lot of families, we've seen a significant increase in applications since it was launched last September. [As of the first week of March, there were a total of 277,096 applications and 111,735 closed loans, with an expectation of another 190,000 closed loans by the end of 2008—bringing the total to 300,000 closed loans.]

Q: *How is the HOPE NOW program of loan modifications doing?*

A: If you go back to July 2007, over 1 million loans have been worked out [by servicers, including those under the HOPE NOW initiative]. Over 600,000 of the [million] were subprime. And then if you go closer into the data that is most recent, we saw a significant uptick in the percentage of modifications or workouts from December and January. But we are following this very, very closely to see how the data progresses and how the data comes in. [It's also worth noting that] short-term rates are much lower than they were when this program was finalized and implemented—[and as a result of the lower rates,] the payment shock associated with the resets is mitigated, and that's to the benefit of borrowers.

Q: *What needs to happen before we can see recovery in the non-agency secondary market—including what needs to happen at credit-rating agencies and the bond insurance companies facing potential ratings downgrades?*

A: Let me go to the recovery of the non-agency market

“In the secondary market for mortgages, the market that is performing best is the one that has a GSE guarantee.”

first. The premise of investing in collateralized investment vehicles is [based on] whether or not you have confidence in the underlying collateral. And I think investors are going to do due diligence to figure out where these mortgages were originated and what were the underwriting standards associated with those mortgages, and then they'll come back into that marketplace. I think we're starting to see that now. And I think we're expecting to see that trend.

On the financial guarantors, I think that it's obviously something that's not regulated at the federal level. It's regulated on the state level, but I think all the market participants are communicating with each other on the best way to deal with the challenges that that industry is facing. I think that's why the market is going to foster a good solution for that.

And credit-rating agencies, that's something we're spending a lot of time looking at here and in the President's Working Group on Financial Markets. I guess I'd make two points about credit-rating agencies. The first is they perform a very valuable service for our capital markets. We want capital markets with credit-rating agencies rather than without them. That's very clear. [Secondly,] I think it's safe to say there's an over-reliance on credit-rating agencies in making investment decisions. And that's something we're taking a closer look at right now, and how you deal with that situation. That's a harder issue because you're dealing with trying to change people's behaviors.

Q: *Generally, investors are going to pay a lot more attention now when they are considering investing in mortgage bonds and derivatives. But do some institutional investors have the resources to do all the due diligence?*

A: Most of your CDO [collateralized debt obligations] and CMO [collateralized mortgage obligations] and mortgage-backed investors are sophisticated investors. A very significant percentage of those offerings are private offerings. They are not even offered as public offerings. That private offering is conditioned on the fact they are sophisticated investors. They do need to do due diligence before they make investments.

Q: *Or certainly have the motivation to do it?*

A: They do now.

Q: *Federal Reserve Chairman Ben Bernanke is encouraging Fannie and Freddie to raise more capital so they can do more lending. What is your view of that?*

A: Yes, that's very consistent with what Secretary Paulson has said about financial institutions. Financial institutions should be strengthening their balance sheets. One way to strengthen your balance sheet is to raise capital.

Q: *Any observations or concerns around expected higher losses from some large banks, and the ability of some banks to*

raise the necessary capital from both domestic and foreign sources?

A: Well, the federal bank regulators were testifying [recently on Capitol Hill about this]. They said [that] right now, almost all banks are well-capitalized. The larger banks that were looking for capital were able to get it. I guess I would want to go back to what the secretary said, and he's exactly right. If you think you're going to need [capital], you should go and get it. Don't wait until you absolutely, positively need it. If you're going to need it, you should go and raise it.

Q: *What can you tell us about the comprehensive review for broad reform of the regulatory structure for financial services?*

A: It's one of the secretary's biggest projects. It's one of the biggest responsibilities [with which] he has tasked me. We expect to have some recommendations by the end of [March]. [Editor's note: The proposal was publicly released in Washington, D.C. on March 13.]

Q: *What are the lessons learned and being learned from the fact that bank and securities regulation failed to see the considerable underlying weakness in the whole process of securitizing non-agency mortgages?*

A: I just want to make one point [about] what you just said. It's bank regulators. It's securities regulators. Sure. I think that's fair criticism. But that's an unfinished statement—it's also the investors themselves. Our system of investment in the United States is premised on sophisticated investors performing an enormous amount of [due] diligence before they commit capital. And securities regulation and bank regulation [are] not geared to prevent investors from losing money. It's to prevent them from being defrauded. It's to prevent them from not being given adequate information about the risk they are taking. It's to prevent investors from [being denied] access to information they need to make informed investment decisions. [It appears to be that] the information was available for investors. While it is true there was an over-reliance on credit-rating agencies, probably all three of those people you mentioned—the bank regulators, the securities and the investors—[failed to see the underlying weaknesses]. Others may disagree, but I feel quite strongly that sentence needs to have an investor component to it as well.

Q: *Then there are the people who put these deals together. Should they have known the structures would not perform under stress? Did they really think through all of this?*

A: Sure. The instruments themselves are quite complex, but the investment decision is not as complex. Does the investor believe the underlying collateral for the investment is sufficient, and in a period of illiquidity, what affect will that have on the value of that asset? What we have right now is a credit contraction in a prolonged period of illiquidity. That has consequences to non-publicly-traded securities. Investing professionals know or obviously should have known [this] would affect the value of those assets.

Q: *Some of the stress tests employed by the people who put together these deals were not sufficiently severe and did not include declining house prices as one of the scenarios. Was*

“We want capital markets with credit-rating agencies rather than without them. That’s very clear.”

that a factor?

A: Sure. The stress testing needs to be re-evaluated, but then you have to determine how severe stress tests should be. I like to think about it the way insurance companies look at their risk profiles. When you're underwriting insurance in the country, you know that Florida is riskier than the middle of the country for hurricanes. So you model that out. So you describe that. Most insurance companies aren't modeling for the Category 5 hurricane. I'm not suggesting what we're going through now is a Category 5 hurricane, but it's a question of how broad [should the stress test be]? Does your stress test take into account every scenario, no matter how dramatic it is? Or, does it take into account 98 percent of the scenarios, or 97 percent of the scenarios, 96 percent of the scenarios?

Models are always based on premises that will sometimes fail. I think that one of the fundamental problems with our stress testing and models today is an over-reliance on credit-rating agencies. Triple-A-rated structured securities were viewed [by investors as] the same as triple-A-rated corporate bonds. And a lot of the underlying credit of those structured securities may be equivalent to a bond, but the volatility of those instruments is pretty different.

Q: *But still, it would seem that there was no stress testing at all for the possibility of declining house prices. It might be rare. I don't know the category of hurricane equivalency.*

A: I don't mean to be defending the stress testing whatsoever. There needs to be an evaluation of what type of testing

needs to be done and how it needs to be done. I'm just trying to say all models are dependent on the inputs you put in. And some of those assumptions you make in the model may prove to be wrong. One of the inputs that was clearly wrong was reliance on triple-A ratings.

Q: *How long do you think it will be before we see any evidence of a turnaround in the credit markets and the secondary mortgage market?*

A: I would be crazy to [try to] predict. It's just going to take a while for these things to play out. You have a reappraisal risk; you have a rethinking of investor practices for structured securities; you have credit-rating agencies rethinking how they rate and evaluate these securities. All of that takes time—although we're seeing some encouraging trends.

Q: *Do you think that the administration may want to undertake even broader measures and interventions to bring stability to the markets and mitigate the economic fallout from the depressed mortgage and housing sectors?*

A: Well, we're very focused on what we're proposing. We're still pushing to get FHA modernization through Congress. I think the secretary's made it clear that we're not looking to provide a government bailout to lenders, speculators and Wall Street. And many of the proposals that have been offered are just that. **MB**

Robert Stowe England is a freelance writer based in Arlington, Virginia. He can be reached at rengland@us.net.

REPRINTED WITH PERMISSION FROM
THE MORTGAGE BANKERS ASSOCIATION (MBA)