



**Submission for the Record by the Securities Industry and Financial Markets Association**

**House Committee on Financial Services**

**Hearing entitled "Building a Sustainable Housing Finance System: Examining Regulatory Impediments to Private Investment Capital"**

**April 24, 2013**

## Introduction

SIFMA is pleased to present this statement regarding impediments to the return of private capital funding mortgage credit for the record of the Committee's April 24 hearing. In 2010, SIFMA<sup>1</sup> submitted a response to a request for comments from the Department of the Treasury regarding reform of the housing finance system. This testimony serves as a "Where are we now?" update to SIFMA's response of three years ago.

SIFMA's members strongly desire the restoration of significant levels of private capital participation in mortgage credit. Our members want a mortgage market that balances access to credit with prudence and stability. A 100% government guarantee for over 99% of mortgage-backed security issuance is neither prudent nor a sustainable way to fund access to housing in this country. However, a prudent and stable mortgage market is essential so that the vast amount of economic activity that is related to housing may support the economy and job creation.

The current housing finance system began in the 1930s. A complete overhaul of a system 80 years in the making is a very large task which will take years, if not decades, to accomplish. SIFMA members believe this overhaul will be best accomplished through a series of incremental steps that invite greater amounts of private capital to participate in taking meaningful credit risk, while preserving the liquidity and beneficial components of the market such as the To-Be-Announced market.<sup>2</sup> As we will discuss below, the level of fundamental change market participants have already been required to process is straining infrastructure and limits the capacity to institute more change.

A critical step remains the establishment of a national goal by policymakers who will determine the future of these markets. As we said in 2010,

*"There is no single "right answer" or any easy solution to the question of how to resolve the conservatorships of the GSEs and define the future infrastructure for mortgage finance in the U.S. Policymakers are faced with a series of difficult choices, each with its own costs and benefits, which will shape the future of housing finance. Ultimately, this essential infrastructure is both a creation of and a reaction to past public policy choices, and as such the future of it will grow out of further determinations of what is the appropriate public policy regarding mortgage finance."*

There is a clear desire for private capital to more frequently stand in a first-loss position, but beyond that there remain many views on the appropriate role of the government in mortgage finance and the standards for access to mortgage credit. There are also many uncoordinated regulatory efforts where the aggregate impact is not, and by definition cannot be accurately estimated. While the stated purpose of most of these efforts is to make the markets safer and more transparent, we are concerned that consideration has not been given to functionality of the industry when re-regulation is completed. The most serious danger is that at some point the pace of change

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<sup>1</sup> SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit [www.sifma.org](http://www.sifma.org).

<sup>2</sup> For an overview of the To-Be-Announced (TBA) markets, please see SIFMA's TBA Market Fact Sheet, available here: <http://www.sifma.org/workarea/downloadasset.aspx?id=23775>

may cause the mortgage finance system to fail; it is unclear if the system would then be able to offer a viable mortgage product to borrowers.

### ***The Need for Market Participants to Understand the Rules of the Road***

For the last five years the rules for lending, securitization, investing, capital, and trading have been in a state of constant change. Market participants make capital allocation decisions based off of a set of facts and expectations at a given point in time; this is difficult when facts and expectations change regularly. Lenders and securitizers need to know that securitization is a long-term funding option so that they can build their businesses around it. Currently, there are many concerns for lenders as to the value of MBS as a funding strategy. The question is whether securitization will be economically attractive compared to funding alternatives such as deposits or debt issuance. If it is not, we believe that the ability of the market to fund credit creation will be severely impaired.

- Understanding future size and scope of the government guaranteed market will allow originators to be in the best position to determine longer-term lending strategies.
- The TBA MBS market plays a critical role in providing market participants the ability to hedge interest rate risk and sell loans into a liquid forward market. The liquidity of this market is fostered through the guarantees provided to MBS that trade in it; while the appropriate size and nature of future government involvement is yet to be decided, SIFMA believes that implementation of reforms should involve consideration of their impact on the liquidity of TBA markets.
- A degree of certainty has been granted by the promulgation of the Qualified Mortgage (QM) final rules, but lenders and investors are still working through their implications. They will not be effective until 2014, so the examination and enforcement regime is unclear -- but very important.
- The “Qualified Residential Mortgage” (QRM) rule proposal, when finalized, will determine the types of mortgages that have the least capital-intensive funding available, and may tend to be the mortgages of choice for many lenders, especially those who are less capitalized.
- The “Premium Capture Cash Reserve Account” (PCCRA) provisions of the risk retention rules, as proposed, would require a securitizer to retain in a first loss position all proceeds in excess of the par value of the loans for the life of the transaction. Under current accounting guidance, application of PCCRA would effectively restrict the ability to receive sale treatment in capital markets transactions for mortgage loans. This will render many transactions uneconomical, and harm borrowers by restricting their ability to lock rates, finance closing costs and obtain other features borrowers traditionally enjoy. PCCRA should be eliminated.
- SIFMA’s sponsor, issuer, and dealer members are concerned that the application of public-style disclosure rules to privately issued securitization transactions (i.e. those issued pursuant to Rule 144a) could limit the utility of securitization for many transactions. However, Regulation AB2 has not been finalized so the future is uncertain.
- The U.S. implementation of the Basel III capital rules could significantly impact the capital cost of mortgage lending and servicing, and put U.S. banks at a competitive disadvantage to foreign banks. The revisions to the Basel Securitization Framework, which are currently in the discussion stages in the Basel Committee, may entirely eliminate the economic utility of various kinds of securitization.

We also note and commend the strategic goal of the FHFA to modernize and develop a common securitization platform for the activities of the GSEs. As we understand the effort, the FHFA is directing the GSE's to coordinate an upgrade of their infrastructure so that they will have a common method of conducting business. This initiative will make the mortgage finance system more efficient and save the taxpayer money. We believe that a better understanding of the longer-term goals for this initiative and public comment thereon is appropriate; any significant changes to the nature of interaction with the GSEs will have broad impacts on both lenders and investors in MBS. In particular, if the goal is to facilitate credit risk intermediation within the private sector, further input on both the physical infrastructure and corporate governance of the new organization is necessary. In particular, we believe that private capital is unlikely to use this organization to its fullest extent if meaningful ownership and corporate representation are not made available to the private sector.

***The Need for Investors to Have Faith in Products, Practices and Government Policies***

Investors must regain confidence in the products, processes, and importantly the stability of government policies at the state and federal level before they will put significant debt capital at risk. It is not true that simply because mortgage assets are for sale an investor will buy them at a price that creates a mortgage rate that is attractive to the mortgage borrower, especially in the context of the size and funding needs of the U.S. mortgage market, which is larger than all European markets combined. We must create an environment that promotes strong investor interest in mortgage securities.

Mortgage investors have endured significant economic losses over the last five years and remain wary of both private mortgage securitization and GSE MBS.<sup>3</sup> They have demonstrated their preference for other asset sectors in the last several years, leaving mortgages more expensive than they otherwise could be.

It is important to note that many of these investors are large institutional investors who invest on behalf of pension funds, mutual funds, 401(k) plans, and other vehicles that channel the savings of ordinary Americans into the financial markets. They represent at an aggregate level the American public, and it is clear to SIFMA that their confidence has not been restored in mortgage securitization. We outline a number of important issues below that remain to be embedded into policy and implemented:

- Understanding future size and scope of the government guaranteed market will allow investors to be in the best position to determine longer-term allocations to the non-agency MBS sector.
- Similar to lenders, investors are active in the TBA MBS market and value its vast liquidity and ability to obtain exposure to interest rate risk as opposed to credit risk. This ability is fostered by the guarantees on the securities that trade in this market. The importance of this market to investors must be recognized in consideration of reforms to the role of the government in mortgage finance.
- Events or actions that upend investor expectations should be avoided. Policy stability is a prerequisite to fostering a large and vibrant market. Investor participation in the policy development process is essential to their future engagement in the securitization markets.

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<sup>3</sup> Among other issues and depending on the type of investor, uncertainties around the guarantee, changes to market dynamics due to quantitative easing, and the general low yield environment.



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- Investors will demand greater loan level disclosure regarding the mortgages that underlie MBS. Reliance on ratings agencies has been reduced. SIFMA investor members support the SEC's proposed disclosure and offering process reforms found in Regulation AB 2.
- Going forward, we expect transaction structures to be simpler, and expect investors to demand greater standardization of structures and documentation. The roles of trustees and other transaction parties will need to be more clearly defined in future transactions.
- Clarifying the ability of investors to enforce the terms of the transactions has become a critical focus of both investors and issuers. In our response to the SEC's proposed Reg AB2 in 2010, our issuer and investor members worked together to develop a regime whereby a third party would serve as a monitor and agent of the investors in the transaction.<sup>4</sup> Some recent securitization transactions have included a similar mechanism and we expect this will continue.
- Lien priority of secured, first lien creditors has been an issue of much contention as loss mitigation efforts have expanded, and will need to be addressed in order to maximize private capital participation in funding mortgage credit.

## **Conclusion**

Investors have suffered significant losses which call into question their desire to participate in mortgage markets. Issuers and originators face daunting uncertainty regarding what products they will be able to produce, how much they will cost, and more generally their business models. Each of these creates a drag on the functionality of mortgage finance markets, and diminishes the level of participation of both investor and lender capital in mortgage markets. We need to set the stage so that private capital desires to return to these markets.

The Committee is rightly focused on reviewing regulatory and legal impediments to this happening, as these are areas where Congress and regulators can play a key role. Other aspects of this problem, such as redeveloping confidence in non-guaranteed residential mortgages as an asset class for investment, can be partially addressed through regulation or legislation, but will also require time and experience with current and new issuances.

In any case, solutions developed in a closed process, where critical participants cannot share their views, are unlikely to be successful. It is critical that policymakers and market participants – all stakeholders including investors, originators, and securitizers – participate in the reformation of the mortgage finance markets.

We applaud the Committee's consistent interest and efforts to create a discussion in this area; SIFMA stands ready to assist the Committee with its work.

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<sup>4</sup> Please see page 6 in SIFMA's August 2010 letter for a full description of the proposed regime, available here: <http://www.sifma.org/issues/item.aspx?id=914>

**Annex: Summary of Specific Legal and Regulatory Impediments to Securitization**

**“Premium Capture Cash Reserve Account” (PCCRA) Provisions in the Risk Retention Rule Proposal (Dodd-Frank Section 941) <sup>5</sup>**

**Impediment**

- The “Premium Capture Cash Reserve Account” (PCCRA) provisions of the risk retention rules, as proposed, would require the securitizer to retain as a first loss position all proceeds in excess of the par value of the loans, for the life of the transaction. This will render many transactions not economical for the issuer, and will likely restrict the ability of the borrower to lock rates, finance closing costs and obtain other features borrowers traditionally enjoy.

**Solution**

- While SIFMA recognizes that the proposed premium capture provisions may have been proposed as a way to support the purposes of risk retention, the actual effect of the PCCRA has much broader and harmful consequences to consumers and securitization markets. SIFMA strongly recommends that the PCCRA be withdrawn from consideration.

**Qualified Residential Mortgage Definition (QRM) <sup>6</sup>**

**Impediment**

- The QRM will define a type of loan for which securitizers will not be required to retain risk. This definition has not yet been promulgated.

**Solution**

- SIFMA investor members broadly support the proposed definition of QRM as a narrower, extremely high credit quality gold standard.
- SIFMA’s dealer, issuer, and sponsor members have advocated for a broader definition of the QRM, such that compensating factors would be allowed to be considered, and the QRM would better reflect the manner in which loans are underwritten.
- In any case, the contours of what is a QRM must be very explicit, and with bright lines outline what is, and what is not a QRM. Compliance with the rules must be readily ascertainable, and should not be called in to question after the fact.

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<sup>5</sup> See SIFMA’s June 2011 letter regarding the risk retention rule proposal, available here: <http://www.sifma.org/workarea/downloadasset.aspx?id=25925>, see also, SIFMA’s January 2012 letter regarding the premium capture provisions, available here: <http://www.sifma.org/workarea/downloadasset.aspx?id=8589937126>

<sup>6</sup> Please the SIFMA Dealer and AMG letters regarding the risk retention proposal, available here: <http://www.sifma.org/issues/item.aspx?id=8589935782> and <http://www.sifma.org/workarea/downloadasset.aspx?id=25926>

## QM<sup>7</sup>

### Impediment

- While the QM rules have recently been finalized, much work remains as the industry assesses the rules. Further, the enforcement and examination process is not clear at this time.

### Solution

- We hope that the CFPB will show flexibility, inclusiveness, and responsiveness to feedback, and be willing to calibrate various parameters of the rules prior to the implementation date. As industry participants work toward implementation of these rules, we expect there will be numerous areas that will require interpretation or clarification by CFPB.

## Eminent Domain Abuse<sup>8</sup>

### Problem

- Various municipalities are exploring the abuse of their powers of eminent domain to seize mortgage loans from private-label securitizations in order to force a refinancing of performing, but underwater, borrowers. If enacted, these plans would destroy investor confidence in securitization, and halt any hopes of returning private capital to mortgage markets. SIFMA has worked extensively around the country to educate policymakers and local officials as to the harm such plans would engender, as well as understanding how significantly the costs exceed any benefits of such action.

### Solution

- If seizures are made and later determined to be defective, the damage will be done when the first loan is taken. It will not matter that they were ultimately determined to be illegal. The consequences to credit availability in the locality will be immediate, and great harm will be done to any progress towards weaning national markets off government support, as private investors will recoil in horror at the unprecedented abrogation of mortgage loan contracts.
- Congress, regulators, and the Administration should make clear their opposition to such plans, and take steps to ensure these unconstitutional and ill-advised policies are not implemented.

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<sup>7</sup> Please see SIFMA's letter on the proposed Qualified Mortgage definition, available here:

<http://www.sifma.org/workarea/downloadasset.aspx?id=8589938566>

<sup>8</sup> Please see SIFMA's Eminent Domain resource activity page, available here: <http://www.sifma.org/issues/capital-markets/securitization/eminent-domain/activity/>

### **Basel III<sup>9</sup>**

#### Impediment

- The rules proposed by Federal Bank Regulators to implement Basel III include significant changes to the regulatory capital regime for mortgages and mortgage servicing. If implemented, the rules could fundamentally reshape the mortgage market.

#### Solution

- The Agencies should eliminate the existing 10 percent haircut for mortgage servicing assets, increase the proposed 10 percent deduction threshold for mortgage servicing assets to 25 percent and grandfather existing mortgage servicing assets.
- Grandfather legacy mortgage exposures to reduce regulatory burden and data constraints.
- Evaluate first and junior lien mortgages separately so that a junior lien does not “taint” the first lien, unless the junior lien is originated and funded at the same time as the first lien in a “piggyback” loan.
- Recognize sustainable loan modifications and restructurings, whether or not they are a part of the Home Affordable Modification Program.
- Recognize private mortgage insurance at both the individual and the pool-wide level.
- Maintain the 120-day safe harbor for credit-enhancing representations and warranties in the current risk-based capital rules.

### **Basel Securitization Framework<sup>10</sup>**

#### Impediment

- The proposed rules will make securitization so expensive that it will not be efficient to use securitization to finance mortgages and far less mortgage credit will be available. The increase will be several MULTIPLES of what the required capital is now. Preliminary calculations show the various methodologies are inconsistent with each other. No QIS has been done yet to demonstrate what the real world cost of the new rules will be.

#### Solution

- The process must slow down and a study be done of the results of the QIS.
- Less punitive capital levels should be proposed and calculation approaches should be better aligned.
- The capital for the various tranches of a securitization should not add up to much more than the pool's capital before it was securitized.

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<sup>9</sup> Please see the SIFMA, ABA and FSR letter regarding Basel III, available here: <http://www.sifma.org/issues/item.aspx?id=8589940758>

<sup>10</sup> See GFMA's letter regarding revisions to the Basel Securitisation Framework, available here: <http://gfma.org/Initiatives/Securitisation/GFMA-Submits-Comments-to-the-BCBS-on-Revisions-to-the-Basel-Securitisation-Framework/>



## **Volcker Rule<sup>11</sup>**

### **Impediment**

- SIFMA is concerned that the regulators' proposed definition of the term 'covered fund' sweeps in a wide range of entities, both domestic and foreign, that have never been considered hedge funds or private equity funds. This may render many beneficial types of securitization impossible for banks. The characterization of certain transactions as commodity pools by the CFTC will also create Volcker-related prohibitions and impact lender risk management capabilities.

### **Solution**

- SIFMA believes that fully excluding most asset-backed securities issuers from the definition of covered funds is required to ensure the practical viability of banking entity securitization and insurance-linked securities transactions.

## **Dodd-Frank Act Section 621 (Conflicts of Interest)<sup>12</sup>**

### **Problem**

- The SEC's proposal to implement section 621 of the Dodd-Frank Act has the potential to prohibit certain kinds of beneficial, risk mitigating securitization transactions, and to impose very significant compliance cost burdens on securitizers, and in some cases could force financial institutions to choose between securitization and other activities, such as lending or investing.

### **Solution**

- The SEC should amend the proposed rules that would implement section 621 in a number of ways, such that the SEC creates a framework to prohibit "designed to fail" transactions, while still allowing for the issuance of ABS without the uncertainty of over-broad or vague regulations or undue restrictions or prohibitions. SIFMA's more specific concerns and recommendations to the SEC regarding the implementing regulations are set forth in our comment letters.

## **Covered Bonds<sup>13</sup>**

### **Problem**

- SIFMA believes that covered bonds can play a limited, but important role in providing cost-effective funding for mortgage loans. However, this will not happen without a regulatory framework for the issuance and oversight of U.S. covered bonds, including the requisite clarity on

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<sup>11</sup> Please see SIFMA's February 2012 letter regarding the Volcker Rule and Securitization, available here:

<http://www.sifma.org/issues/item.aspx?id=8589937357>, see also SIFMA's May 2012 letter proposing a specific exemptive framework for securitization, available here: <http://www.sifma.org/issues/item.aspx?id=8589938859>

<sup>12</sup> See SIFMA's letter to the SEC on the Section 621 rule proposal, available here: <http://www.sifma.org/issues/item.aspx?id=8589937359>

<sup>13</sup> Please see the June 2011 SIFMA and US Covered Bond Council letter to the US House Financial Services Committee on the United States Covered Bond Act of 2011, available here: <http://www.sifma.org/workarea/downloadasset.aspx?id=26016>



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investor's rights in case of an issuer's insolvency. In 2011, both House and Senate versions of legislation were floated, but neither progressed.

- Congress should pass legislation similar to that noted above, in order to allow a covered bond market to play some role in mortgage finance.