



July 20, 2010

**RE: Public Input on Reform of the Housing Finance System**

*eDocket Number: TREAS-DO-2010-0001; eDocket Number: HUD-2010-0029*

SIFMA<sup>1</sup> is pleased to submit this response to the Administration's request for comment on reform of the housing finance system. The financial reform legislation that has recently been passed by the Congress represents a comprehensive and critically important reformation of many aspects of the financial infrastructure of the United States. It will affect nearly all aspects of banking, capital markets, and consumer interaction with the financial system. One area it did not address, which is equally important, is the mortgage finance infrastructure of this country. While mortgage finance may seem to be a topic with a limited and defined scope, it is easy to underestimate the importance of mortgage finance and all of its ancillary aspects to the U.S. economy. Therefore, Treasury and HUD are right to move with all deliberate speed to address questions that linger around the future of this important part of the economy, and more specifically questions that surround the Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac. SIFMA believes that the process of discerning the appropriate way forward for these issues is an immensely complex process that cannot be rushed, but at the same time must be undertaken with the appropriate urgency and resolute determination to ensure that an appropriate conclusion is reached.

**Executive Summary**

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. The request for comment is rightly very broad, and covers many aspects of housing finance. While there are many important questions, we believe a special and near-term focus needs to be placed on resolution of the current status of the GSEs. Therefore, the bulk of our response is focused on the multitude of issues connected to this topic.

In late 2009 SIFMA formed a GSE Reform Task Force<sup>2</sup> comprised of members of the Association involved in all aspects of mortgage lending, from originators to investors and the market makers that create liquidity between them, to discuss and develop shared views on what are the most critical aspects of GSE reform for secondary mortgage markets. The Task Force developed this response to share its

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<sup>1</sup> The Securities Industry and Financial Markets Association (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).

views with policymakers and others concerned about these issues. The discussion herein will address a number of issues and considerations that were determined to be significant by this Task Force and of particular interest to participants in the secondary markets for mortgage loans and mortgage backed securities (MBS). The paper does not propose any single comprehensive solution to the series of choices policymakers face; rather, it outlines a number of factors and considerations that should be used as inputs into the policy development process. A complementary goal of this document is to provide education and develop a base of knowledge about how these important markets operate. The work of the Task Force will continue, and delve into issues in more detail as specific areas of focus become clearer. Consequently, it is clear from the outset that the analytical and developmental process to be undertaken at the Department of the Treasury should be broadly inclusive explorations of the housing finance system, performed with depth and cross-sectional considerations, with adequate time and resources.

We note that it is generally clear what a path involving complete privatization of the mortgage finance industry would look like. Without the benefit of government support, mortgage credit would be less available and would be more expensive. Note that credit would be less available not only because lenders may not be able to support current volumes in a totally private market, but it would also be less available from the perspective of a consumer, because it would be less affordable. The exact impact in each of those areas, availability and cost cannot be determined with precision, as the impact is dependent on a number of economic and other factors, but at a high level, we do not doubt the directional impact of such a course of action. This is the first policy question that members of Congress and the Administration face: should the government provide material support mortgage lending?

A brief summary of the high level conclusions and considerations discussed in the paper follows:

- Secondary mortgage markets will continue to function regardless of what policymakers decide as 'there is a price for everything'. The price, however, is not always desirable to everyone. The issues for policymakers to consider are: how liquid secondary markets for loans and MBS would be, the breadth of products that would be offered to consumers, the capacity of lenders to extend credit, whether national lending markets could be sustained or if regional pricing differentials would reappear, and, ultimately, the cost and affordability of credit to consumers.
- Accordingly, policymakers need to determine what they want from the mortgage markets before they can address what to do with the GSEs or the broader infrastructure of mortgage finance.
- The GSEs, for all of their faults, have conferred significant benefits on U.S. mortgage markets. It is indisputable that these faults must be rectified and a new structure for the markets designed that will eliminate, or at least substantially mitigate, the source of these faults. We caution that the urge to "slay the dragon" should not cause collateral damage that would eliminate or make impossible the beneficial impacts and legacy of the old system that developed around the GSEs. One of the most important, if not the most important, was fostering the development of a liquid forward market for mortgage backed securities, known as the "to be announced" market or TBA, which allowed lenders to hedge risk, attracted private capital, and reduced the cost of mortgage lending. SIFMA's Task Force believes that this TBA market is the key to a successful, liquid, affordable, and national mortgage market, as well as ensuring a sufficient level of capital is available to banks to lend. The historically huge and liquid global market for GSE MBS is initiated by the TBA mechanism.
- Some form of an explicit government guarantee on MBS will be required to maintain the liquidity of the TBA MBS markets. Purely private sector solutions cannot accomplish this important goal.
- There are a number of permutations of a guarantee, but ultimately, a government insurance wrap of the MBS that stands behind any private sector insurance or other corporate guarantees, as a catastrophic backstop, may be the most efficient means to achieve this goal.

- In terms of whether or not a GSE is needed at all, how many are necessary, and other corporate structure issues, a number of options are available and could be implemented. There are policy choices to be made, and tradeoffs do exist. Regardless of what path is chosen, an eye must be kept toward preserving the simplicity and homogeneity of the GSE MBS markets in order to preserve the important liquidity provided by the TBA markets.
- Portfolios present a number of choices for policymakers. While they are necessary at some de minimis level for purely operational reasons (assuming GSEs or similar entities exist), moving beyond this operational level presents a number of challenges and choices for policymakers. If there is a goal to provide a mechanism to smooth out volatility of mortgage rates, portfolios are one way to accomplish this. Whether or not these roles are desirable on a risk vs. value basis and should be continued is a question for policymakers to decide.
- The resolution of the conservatorships of the current GSEs will clearly be a challenge. SIFMA task force members believe that the government must clearly state intentions with respect to legacy GSE issues prior to and during any transition. Bifurcation of markets into pre- and post-reform markets should be avoided. In this manner, supporting market and investor expectations through a continuity of the existing perception of a guarantee will engender future market stability and resulting investor participation. The alternative – essentially abandoning an existing market – would have serious and long term consequences for the global flow of capital to the United States.

We hope that the discussion that follows is useful and informative to the Administration as it considers this vitally important public policy issue. SIFMA stands ready to provide any needed information, support, and analysis during this process. Please do not hesitate to contact me or any of my staff with any questions or for more information.

Sincerely,



T. Timothy Ryan  
President and CEO



Richard A. Dorfman  
Managing Director, Head of Securitization

**1. How should federal housing finance objectives be prioritized in the context of the broader objectives of housing policy?**

- ***Commentary could address: policy for sustainable homeownership; rental policy; balancing rental and ownership; how to account for regional differences; and affordability goals.***

One important point that should be made before a more detailed discussion of granular issues is that policymakers should determine how they envision the future of mortgage finance, and what goals they have for the U.S. mortgage markets before they delve into the specifics of various forms of corporate organization and other detailed issues related to the GSEs or any other aspect of the housing finance system. Drawing the lens back to a very high level, mortgage markets will continue to function, at some level, regardless of what policymakers decide – to repeat the common phrase, ‘there is a price for everything’, and markets will always find an equilibrium of supply and demand. The price and terms, however, are not always desirable to everyone. The issues for policymakers to consider are: how liquid the secondary markets for loans and MBS will be, the breadth of products that would be offered to consumers, whether or not 30 year mortgages could continue to be the primary term structure, the capacity of lenders to extend credit, whether national lending markets could be sustained or if regional pricing differences would reappear, and ultimately the cost and affordability of credit to consumers.

Before any other decisions can be seriously contemplated policymakers need to determine what they want from the mortgage markets. Considerations include: are national markets where the cost of a loan in Denton, Texas is similar to the cost of a loan in Portland, Maine desirable? Is there a policy basis for supporting and bolstering the liquidity of the mortgage markets and therefore reducing the cost of credit to consumers? Is the 30 year fixed-rate mortgage something that should be preserved? Is there a policy basis to support the securitization markets and the service they provide by facilitating the flow of capital from investors to homeowners? Should the government play a role in encouraging affordable rental housing funded by multifamily lending? Arguably, all of these things stem from, or have been historically bolstered by, Federal engagement in the mortgage finance system.

Our task force believes the answer to all of these questions is ‘yes’, and accordingly assumes these goals to be relevant. National mortgage markets should be maintained, and liquid secondary markets are necessary for them to exist. The broader economy is well served when mortgage rates are generally affordable to a large number of appropriately qualified consumers, given the important contribution of housing and all of its ancillary industries to GDP and employment. Therefore, our perspective is that some form of government support for mortgage markets should be provided, either through a GSE, GSE-like entity, government provided insurance, or some other means.

Our task force believes that an enhanced support system for enhanced rental credit underwriting standards looks back to the fundamental precept that individual ownership of housing, while an elemental social goal, cannot prudently be available to all citizens. In fact, the social goal should be quality housing shelter, whether ownership or rental, appropriately balanced with financial prudence. In this context, rental housing has a major role in the future and presumably a bigger role than it has today.

Affordable housing is a policy goal and we do not comment on whether or not it is an appropriate policy goal. However we believe that any implementation should be expressed transparently. Further, the implementation of affordable housing programs should be accomplished independently of the securitization process, and not buried within securitization structures and processes. Doing so will create distortions and lead to outcomes that are overall less efficient, and at worst, potentially harmful,

**2. What role should the federal government play in supporting a stable, well-functioning housing finance system and what risks, if any, should the federal government bear in meeting its housing finance objectives?**

- ***Commentary could address: level of government involvement and type of support provided; role of government agencies; role of private vs. public capital; role of any explicit government guarantees; role of direct subsidies and other fiscal support and mechanisms to convey such support; monitoring and management of risks including how to balance the retention and distribution of risk; incentives to encourage appropriate alignment of risk bearing in the private sector; mechanisms for dealing with episodes of market stress; and how to promote market discipline.***

*Role of the Federal Government in Housing*

Task force members have concluded that some form of explicit government support is needed to attract sufficient investment capital to maintain liquidity and stability in the conventional mortgage market at a level comparable to that created over the last 30 years. Members believe that total privatization of the GSEs and mortgage finance will likely result in greater volatility, increase inefficiency, and ultimately make mortgage loans more expensive for consumers. While this document generally does not address issues of pure public policy, as these are decisions to be made by members of Congress, Task Force members do believe that there should be a role for the government in promoting liquid mortgage markets.

To promote liquid mortgage markets, Task Force members agree that any future form of the GSEs (or other government support) will require some form of an explicit government guarantee on certain MBS issuances. Our Task Force members do not believe that investors will support a return to an implicit guarantee, and also agree that a GSE or successor MBS program without a guarantee (i.e. an explicit non-guarantee) will not allow the GSEs or successor entities to meet any policy objectives. We note that loan level guarantees are not necessary if the security carries a guarantee. This need for an explicit guarantee after the conservatorship concludes applies to both future MBS issuances and currently outstanding MBS and corporate debt.

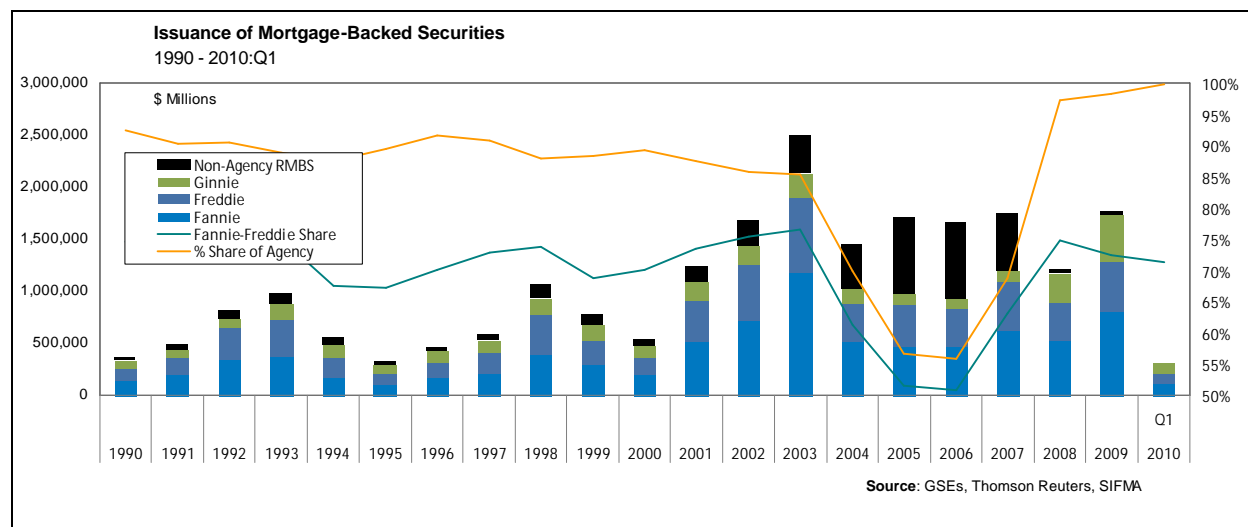
It is important to note that the GSEs, setting aside their current situation and flaws, were important contributors to many benefits to homeowners and the economy. It can be argued that a 30 year, fixed rate mortgage would not be considered the “standard” mortgage product today but for the GSEs. The GSEs have also driven a great deal of standardization of mortgage loan documentation and other operational processes that make mortgage lending more efficient and cost-effective. Most importantly, the GSEs have fostered, in conjunction with industry participants, the To-Be-Announced (TBA) secondary market for mortgage-backed securities (MBS). This market developed out of the standardization of mortgage products and securitization driven by the GSEs. SIFMA’s Task Force believes that this TBA market is the key to a successful, liquid, affordable, and national mortgage market, as well as ensuring a sufficient level of capital is available to banks to lend.

*The Conventional Mortgage Market and the Historically Important Role of the Government*

Fannie Mae and Freddie Mac alone support approximately 60% of all originations nationally. In the aftermath of the credit crisis, Fannie Mae, Freddie Mac, and Ginnie Mae through their MBS issuances and/or guarantees support over 90% of mortgage originations. At the end of 2009, approximately \$5.5 trillion of GSE and Ginnie Mae MBS was outstanding, supporting half of all outstanding first-lien mortgage debt (the other half is retained on bank portfolios or is funded in the non-agency MBS market). Figure 1 (below) illustrates the heightened importance of Federal engagement in mortgage finance. For context, there were about \$7 trillion of U.S. Treasury securities outstanding at the same time. These numbers are meant to illustrate the importance, both historically and especially currently, the sheer size and the significance of the conventional and FHA/GNMA mortgage markets. There is one common feature among the FHA/GNMA and GSE programs – government support. This support has provided much

benefit to American homeowners – it has expanded the availability of credit, reduced costs through standardization and driven economies of scale.

Figure 1 – Issuance of MBS



It is indisputable that the faults of the current system that are now painfully evident must be rectified, and a new structure for the markets designed that will eliminate, or at least substantially mitigate, the source of these faults. We caution, however, that the urge to “slay the dragon” should not cause collateral damage that would reverse, or make impossible to sustain, the beneficial impacts and legacy of the old system that developed around the GSEs. It is important to note that GSEs have conferred benefits beyond the conventional market. Standardization, discussed below, is one such example. We also note that GSE MBS markets serve as benchmarks and signals to non-GSE markets in terms of pricing. Additionally, a GSE-related concept, that of a “qualified mortgage” as delineated in the recent financial regulatory reform legislation (H.R. 4173, the Dodd-Frank Act), represents in some ways the exportation of GSE-like underwriting criteria to the broader mortgage markets. In other words, the GSE markets serve as both a model and a point of reference for all mortgage markets. Clearly, what was once akin to a gold standard has become significantly tarnished, but that does not mean it needs to be destroyed in its entirety.

Standardization has been a key benefit of the GSE model in the conventional market. Due to their size and the scale of their operations, the GSEs have driven standardization of mortgage loan documentation, underwriting, and other items in ways that have created a more efficient origination process. This standardization extends beyond the Agency market, and has driven standardization of lending processes more generally, across product types, and across institutions.

Perhaps more importantly, government engagement combined with the activities of the GSEs have driven the standardization of loan maturities out to 30 years, creating a mortgage product that is affordable to a greater proportion of consumers. Most people take for granted that typical mortgage loans have a 30 year term, but given the nature of bank funding, this is not a natural outcome. Before the implementation of government programs such as the Homeowners Loan Corporation, FHA, and Fannie Mae in the 1930s, mortgages tended to be short term and require a balloon payment at the end of the term. This was directly related to the short-term nature of bank funding; many institutions derive a majority of funding for lending from customer deposits which are redeemable upon demand. The development of secondary markets for loans and MBS through government initiatives allowed banks to extend loans with longer

terms, as banks were able to access a longer-term funding source (in addition to transferring risk, reducing balance sheet utilization, and reducing demands upon limited capital) in the form of loan sales into active secondary markets and ultimately securitization. Without the initiatives undertaken by the government in the 1930s and the continuing support of the GSEs, it is not clear that today's mortgage loan would have a 30 year term.

*Benefits of a Guarantee – Liquidity, Stability, and Lower Mortgage Rates through the Attraction of Substantial Domestic and International Investment Capital Flows*

The implicit guarantee on GSE MBS historically reduced the issuance costs for those bonds because it attracted a number of important classes of investors and provided for the development of a large, extremely liquid secondary market. These investors include pension funds, mutual funds, bank portfolios, insurance companies, and significantly, foreign central banks and other substantial foreign investors. Non-U.S. institutions hold hundreds of billions of dollars of GSE MBS – this represents hundreds of billions of dollars that have been channeled into the hands of U.S. homeowners – and along with banks and the GSEs themselves, foreign investors have been one of the largest buyers of these securities. Many of these institutions are extremely sensitive to credit risk, and it can be argued that an important part of the rationale for the entry of the GSEs into conservatorship in 2008 was to assuage the concerns of investors that an element of credit risk had been introduced into a market that depends on the absence of such risk. Prior to the conservatorship, the GSEs began to experience greater difficulty issuing corporate debt, and spreads on MBS products began to widen, in part due to a reduction in foreign investment. Task force members agree that in the future these investors will not accept an implicit or non-guaranteed MBS product.

These institutions are attracted to the GSE MBS markets for a variety of reasons, but chief among them are the safety of the investments and the liquidity that the market provides. We earlier detailed the scale of the GSE MBS markets; when this scale is combined with the homogeneity of collateral that backs the securities and securities themselves, the result is a market where investors are able to invest significant sums of money in a timely fashion without creating undue distortions to prices. GSE MBS has become an essential component of many investment fund mandates. For example, many investors benchmark their funds against various indices. In one commonly referenced index, the Barclay's U.S. Aggregate Index, MBS represent over 1/3 of the index. GSE MBS provide a safe, liquid investment product for many 401k plans, pension plans, and insurance companies. Without this asset class, these investors would struggle to replicate the combination of liquidity and return, and would either move towards lower yielding products such as Treasuries, or into riskier products such as corporate or other sovereign debt. Such shifts in asset allocation would not only reduce the flow of capital to mortgage markets, but it would also have a negative impact on the performance of those investment vehicles.

This liquid market would not have been possible without the implicit guarantee on the debt. It is notable that no other mortgage market or funding system via depositories has ever provided sustained liquidity to the extent that the GSE MBS markets have. It is also notable that each secondary mortgage market that was not the beneficiary of a guarantee collapsed in 2008. The GSE MBS markets are considered "rates" markets, as opposed to "credit" markets, similar to the Treasury market. Investors in these markets do not need to, and do not want to, engage in detailed loan-level credit analyses of the securities they are investing in. Rather, investors look to take positions based on their views of interest rates (and resulting payment speeds of the underlying borrowers) and other macro- and microeconomic factors that drive borrower behavior. Furthermore, many investors in GSE MBS are only investors in these products due to the implicit guarantee. If the guarantee is removed, they will no longer participate in these markets, in some cases regardless of the yields offered on the securities.

SIFMA's Task Force does acknowledge, however, that a substantially larger, government supported mortgage market could potentially impact the Federal Reserve's management the general levels of pricing of credit in the economy, because the supply of credit could be managed through changes to underwriting standards for loans eligible to be insured, which in some cases could act in an opposing direction to changes in general levels of interest rates. The extent of this impact, and its relative

significance compared to the benefits such a regime would confer on consumers, are unclear, and ultimately determining these answers is best left to policymakers. It is another factor that should be included in the consideration of the future of the U.S. mortgage finance system.

### *The Importance of the TBA MBS Markets Cannot Be Overstated*

The majority of trading volume in the agency MBS markets today is in the form of “To-Be-Announced” (TBA) trading. For background, a ‘TBA’ is a contract for the purchase or sale of agency mortgage-backed securities to be delivered at a future agreed-upon date; however, the actual pool identities or the number of pools that will be delivered to fulfill the trade obligation or terms of the contract are unknown at the time of the trade. Actual mortgage pools guaranteed by one of the Agencies are subsequently “allocated” to the TBA transactions to be delivered upon settlement. Settlement dates of transactions are standardized by product type (e.g. 30 year FNMA/Freddie Mac pools, 30 year Ginnie Mae pools, 15-year pools) to occur on four specific days each month. Monthly settlement date calendars for the TBA market are published one year in advance by a SIFMA committee on a rolling 12-month basis. This is done to increase the efficiency of the settlement infrastructure, and facilitate forward trading. Most trades are executed for settlement within one to three months, although some trading may go further forward from time to time.

For example, Investor A would call up Market Maker A on July 1, and order \$10 million FNMA 5.5% coupon 30-year MBS, for settlement on August 15. The investor does not specify specific bonds or CUSIP numbers. On August 13, according to market practice, Market Maker A would notify Investor A of the specific identities of the pools that will be delivered on August 15. Most likely, these will be MBS that were just issued at the beginning of August.

Similarly, and importantly, a loan originator can enter into forward TBA sale contracts, allowing them to hedge the risk of their loan origination pipelines. This permits the lenders to lock in a price for the mortgages they are in the process of originating, benefitting the borrower with the ability to lock in mortgage rates earlier in the process. Pricing on loans varies from day to day with fluctuations in the TBA markets, and lenders will often re-price loans for their bankers and correspondent partners on a daily basis. Thus mortgage bankers follow the market in order make decisions on when to lock in a rate for a borrower.

There are currently over \$3 trillion in bonds eligible for TBA trading – it is a vast market. It is also extremely liquid – Federal Reserve data shows average daily trading volumes of Agency MBS reported by the Fed’s primary dealers as exceeding \$300 billion *per day* over each of the last 3 years. Private estimates of daily TBA trading volumes exceed \$600 billion (these estimates take in to account trading beyond that of the primary dealers). Liquidity in this market is second only to the market for Treasuries. This liquidity allows investors to buy and sell significant quantities of securities quickly and without disrupting the market. This makes the market very attractive to these investors who have substantial funds to be invested.

As mentioned above, the TBA market is the most liquid, and consequently most important, secondary market for mortgage securities. In this time of distress, the importance of the TBA market is heightened, and it is difficult to exaggerate the consequences from a loss of confidence or liquidity in this market. The effects would be directly and immediately felt by the average mortgage borrower. The impact would include, at a minimum, higher mortgage rates, as yields required by investors would rise as liquidity falls. It is also likely that credit availability would be constricted. This would occur because secondary market executions for originators would be more expensive and take longer, requiring longer warehousing periods for loans they originate. Balance sheet capacity is a currently a scare commodity for most lenders, and is finite in any case. Furthermore, the ability of borrowers to lock-in rates on mortgage applications would likely be reduced, creating uncertainty for them and likely depressing real estate activity which is an important component of broader economic activity.



Ultimately the decision to guarantee or to not guarantee is policy choice for Congress. However, our view is that the choice presented is not one of degrees, but is more akin to a binary choice – the result will either be large, efficient, liquid, national conforming mortgage markets, or it won't be. Task force members believe a liquid TBA market is a required and essential component of the mortgage finance system, currently and in the future, with an importance that cannot be underestimated.

#### *Purely Private Sector Insurance Solutions Will Not Provide Needed Support and Confidence to Support TBA Trading of MBS*

Some have suggested various models of private market insurance for future MBS issuances. Our members do not believe these private sector models will attract the necessary investor capital and will not foster the maintenance of extremely liquid markets that a government guarantee will provide, and cannot support markets where securities trade TBA. One reason is that private sector mono-line insurance companies have not fared well in recent times of market stress – and in the most recent crisis this applies to both mortgage insurance companies as well as bond insurers. Many insurers have ceased underwriting new business, have entered a wind-down mode, and/or have ceased paying claims on their insurance policies. Clearly private sector solutions were not, and likely will not be, resilient in times of stress. In any case, it is doubtful that investors will believe them to be, which is the most critical consideration. Given the size of the U.S. mortgage markets, any comprehensive private insurance system would have to be so large, and would require so much capital to withstand the proverbial 100 year storm, that it is hard to see how it could be done in a manner that would provide anything approaching equality in terms of cost, efficiency, stability, or resilience to that provided by the GSEs today, unless the private insurance entities are ultimately backed by the government. If they are backed by the government, it is more efficient and less costly for the government to provide the insurance itself directly to the MBS. Private insurance would introduce an element of credit risk into the analysis of the MBS, which as discussed above would immediately eliminate certain classes of investors and would significantly impair the flows of capital to mortgage markets, resulting in higher rates for mortgage borrowers.

#### *The Explicit Guarantee Can Take A Number Of Forms, But Government Re-Insurance May Be Most Efficient*

There are a number of ways that an explicit guarantee on GSE MBS could be structured. The bottom line for a guarantee is that investors must know that they will receive back at least their invested principal.

Currently, both GNMA and GSE MBS also guarantee that investors will receive the scheduled interest payments on a given loan, so long as the loan is outstanding. This means that at times, the GSE or the servicer, depending on the program, must make up what is referred to as a prepayment interest shortfall. For example, a loan might pay off on the 15<sup>th</sup> of a month, but interest is due to the bondholders for the entire month – the lender, servicer, or sometimes the GSE will make up that shortfall. Some have suggested that the guarantee of payment of all scheduled interest be eliminated as a way to decrease the cost of a guarantee. However it will introduce more volatility into the analysis of prepayments and possibly result in investors demanding higher yields to compensate. Therefore, the optimal outcome for mortgage borrowers, in terms of rates, would require the guarantee of payment of these interest shortfall amounts.

One option is a full faith and credit guarantee where the government backs the timely payment of principal and interest on the entire security, similar to the guarantee on GNMA securities. It is important to note that in the GNMA context, the loans that underlie the securities are also guaranteed, by the Federal Housing Administration. This underlying guarantee is not required, however, in the context of GSE discussions. This type of security-level guarantee would provide the necessary comfort to investors that they will see the return of their invested principal. However, this is likely the most expensive form of a guarantee from an accounting perspective, as the government is essentially responsible for a guarantee of each dollar of loss on a bond. This may be appropriate in the context of GNMA, but is probably not in the context of a regime where an entity stands between the government guarantee and investors, with the ability to provide its own corporate guarantee.

## *Government Reinsurance*

Thus another logical, and possibly preferable, structure for a guarantee would have the government re-insure a corporate guarantee on the MBS. The MBS issuer (presumably a GSE) would take on the “first loss” position, and the government guarantee would only be triggered in the event that the issuing entity was unable to stand behind its corporate guarantee. The issuing entity would pay a fee for the use of this government guarantee, which would be determined by the government and could be adjusted based on risk, changing market conditions, or other policy considerations that we do not address here. In benign environments, this guarantee fee would be a source of revenue for the government. In stressed environments, the government may or may not have to pay out on claims; this would depend on the capitalization of the issuing entities and the severity of the market distress. A guarantee of this nature would appear to fulfill dual mandates of comforting investors and ensuring stability in mortgage markets, and minimizing the (real and accounting) costs to the government. We do not believe, however, that this government reinsurance can be pegged at any specific level (e.g., government reinsurance only covers 30% of the face value of the bond and the issuing entity is responsible for the other 70%), as this would introduce credit risk into investment considerations and likely result in tiering of the market if there is more than one issuing entity.

We do note that reinsurance programs of a corporate first-loss guarantee would present certain challenges. In a first loss position, the successor entities (and possibly their regulator, depending on the future framework) would be powerful gatekeepers at key policy points in the housing cycle through their management of levels of guarantee fees. Past experience shows that the GSEs were at times reluctant to make major changes in their guarantee fees, possibly due to a concern that they could be construed as regulating the flow of credit. We note that OFHEO was studying whether g-fees were too high in 2007 due to historically low loss experiences. Providing a future private (or semi-private) enterprise (cooperative or otherwise) with this sort of systemic power will present these same issues, and policymakers should be conscious of them.

Secondly, it may be difficult or impossible to empirically determine the appropriate level of first loss cushion. The likely error will be to the high side, over capitalizing/reserving any new entities. The result of this for homeowners would be higher costs than are truly necessary. On the other hand, if an option is presented to somewhat over- or under-capitalize such an institution, it may be prudent and more politically palatable to err on the side of over-capitalization.

### *Should the GSEs have Private Ownership?*

At this point SIFMA’s task force has not focused on specific permutations of corporate structure for the future GSEs or their successor entities, the levels of capital required for each, and the sources and cost of that capital. At a high level, however, SIFMA members do not believe that some form of private ownership interest in the future GSEs is an unreasonable or unwise outcome on its face. However, as mentioned previously, our focus has been on secondary markets and what is required to preserve the liquidity and other benefits the current regime has conferred upon mortgage markets. Our task force members do agree on one high level concept, however: if some form of a GSE exists in the future, it should be established with a limited and specific charter that outlines a limited and specific mission, along with a strong regulator empowered to regulate and manage the activities of the entity in all appropriate ways, but acts in coordination with entities such as the Treasury and Federal Reserve to ensure the safety and soundness of the broader financial system. Changes to this charter and mission should be solely within the purview of Congress.

### *Can Private Banks, Either Individually or as Consortiums, Replace the GSEs?*

If the government is willing to provide reinsurance for a fee, one can argue that GSEs are not needed; rather, that banks could issue their own government reinsured MBS off their own shelves. This presents a number of challenges that would need to be considered to ensure that liquidity and efficiency are preserved. For one, such a system may favor larger lenders over smaller ones, as small lenders could have problems warehousing loans until they reach critical mass that would support an MBS issuance. It

could also result in smaller lenders being forced to maintain a relationship with a large bank which would serve as an aggregator, which is a role that was previously filled by the GSEs through their cash windows. Given recent accounting rule changes (SFAS 166 and 167), it is also unclear if banks that issued their own MBS would be able to move the assets off their balance sheet to free up regulatory capital that would support further lending. The outcome would depend on the facts and circumstances surrounding the MBS programs. Currently, the GSEs consolidate MBS on their balance sheets, allowing lenders to recycle scarce capital into new loans, ultimately reducing mortgage rates and increasing credit availability. This is an important consideration for any future system.

A reinsurance model would also support an approach whereby cooperatives would be formed and owned by their member banks, with a special charter, akin to the Federal Home Loan Bank system (but with a different purpose). This approach could avoid some of the challenges discussed above.

What is clear from our discussions is a view that a completely privatized system, with no GSEs and no government guarantee, will not be able to support liquid secondary markets for MBS, and will result in significantly increased borrowing costs and significantly lower lending capacity and credit availability. These costs would be even more significant during times of economic distress. That being said, policymakers must determine the appropriate public policy goal with respect to mortgage finance and government subsidies to promote greater availability of mortgage credit. There are a number of options between purely private and purely public alternatives that can be considered each with its own costs and benefits, which may differ depending on one's perspective.

#### *Alignment of Interests*

SIFMA agrees that a general alignment of interests of securitization transaction participants is important, at a high level. In other words, originators, issuers, sponsors, and cash investors should share an interest in transactions where material terms and risks are properly disclosed, and absent external factors, the assets perform in line with expectations. There are a number of methods through which the incentives of participants may be aligned. Chief among these, especially in the context of GSE-issued MBS, are repurchase rules. Sellers of loans to a securitization are generally contractually obligated to repurchase loans that violate a representation and warranty made at the time of the transfer of the loans. The GSEs have proven especially effective at enforcing these contractual risk retention obligations. Outside of the GSE markets, a number of originators have suffered significant losses, or even gone out of business entirely, because of repurchase requirements based on representation and warranty violations.

The process of working through these contractual claims is not always easy outside of the GSE MBS markets where the GSEs have significant ability to compel repurchases; therefore other measures of risk alignment have been advocated such as the retention of economic interests by sponsors of securitizations. Generally, SIFMA supports requirements such as those in the Dodd-Frank Act for transaction sponsors to retain a meaningful economic interest in securitized products, with appropriate regulatory discretion in terms of implementation of such a regime. We believe that retention of such an interest can help to align the incentives of originators and sponsors with securitization investors, thereby helping to restore confidence and functionality to the securitization markets, an essential step in the path to economic recovery and growth. SIFMA believes it is very important that Federal regulators are given the authority to design and apply retention requirements in a manner that specifies permissible forms and amounts of retention, how retention requirements may be calculated and measured, the duration of retention requirements, whether and to what extent hedging of retained interests is permissible, and other important implementation details. We note that as providers of a corporate guarantee of principal and interest on securities, the GSEs retain 100% of the risk of their issuances.

Many also point to alternative structures such as covered bonds, where loans remain on the issuing bank's balance sheet. Covered bonds are often discussed as a replacement for, or an alternative to securitization. SIFMA and its members strongly support the development of a covered bond market in the U.S., and in 2008 SIFMA formed the U.S. Covered Bond Council, which comprises issuers, market makers, and investors in covered bond markets to further this mission. One of the primary goals of this

group is to establish a legislative framework for covered bonds in the U.S., as this is viewed as an essential component of the growth of this market. SIFMA members do not believe, however, that covered bonds should be viewed as a replacement for securitization or the GSEs, especially at this point in time. SIFMA members encourage policymakers to promote and foster a liquid covered bond market, but view it as distinct from, and complementary to, securitization markets such as those for GSE and privately issued MBS.

### **3. Should the government approach differ across different segments of the market, and if so, how?**

- ***Commentary could address: differentiation of approach based on mortgage size or other characteristics; rationale for integration or separation of functions related to the single-family and multi-family market; whether there should be an emphasis on supporting the production of subsidized multifamily housing; differentiation in mechanism to convey subsidies, if any.***

Historically the GSEs and FHA/Ginnie Mae have acted within the bound of conforming loan limits. Thus, government support (implicit and explicit) has been focused on a limited portion of the housing markets. This regime reflected a view that the appropriate recipients of such support were homebuyers and homeowners with lower to moderate incomes, and that higher income borrowers would be served by banks through portfolio lending or private label securitization. Thus, the boundaries between public and private markets were in many ways determined by loan limits. This was not a strict rule, however, as private securitization included products that were below the loan limits but outside of the underwriting guidelines of the GSEs and FHA. Given the implicit support of the GSEs, and the benefits that conferred on their funding costs, private securitization markets generally could not economically compete with GSE MBS for conforming products. If Congress determines that changes to loan limits are necessary, we believe it is important that any changes be measured and gradual, to allow for private sources of mortgage funding to fill in the space once filled by the activities of the GSEs and/or FHA.

As we have discussed previously in this paper the ultimate existence and scope of the activities of the GSEs or their successors are policy questions. However, SIFMA members believe that there was, is, and will remain a role for private securitization markets in U.S. mortgage finance. Our members do not believe the current situation, where the GSEs and FHA support 95% of mortgage lending, is desirable, tenable, or healthy for taxpayers or housing markets in the long term. Therefore, we do believe the activities of any future GSE or successor should be circumscribed and targeted to where their economic impact would be maximized, and that private markets fill in around that space.

As noted previously and in the following section, SIFMA's Task Force supports the activities with respect to multifamily housing, and believes that if GSEs exist in the future that multifamily housing is appropriately within their purview.

### **4. How should the current organization of the housing finance system be improved?**

- ***Commentary could address: what aspects should be preserved, changed, eliminated or added; regulatory considerations; optimal general organizational design and market structure; capital market functions; sources of funding; mortgage origination, distribution and servicing; the role of the existing government-sponsored enterprises; and the challenges of transitioning from the current system to a desired future system.***

#### *Broad, Overarching Conclusions*

At a high level, SIFMA Task Force members believe it is essential to preserve the benefits that securitization brings to lending markets. Chief among these benefits is the creation of a mechanism for private capital, and importantly, international capital, to flow to end users of consumer credit products. As

discussed earlier, banks cannot replicate the scale and scope of these capital inflows with their balance sheets alone – securitization is necessary. This inflow of capital comes through both private securitization as well as GSE and government agency securitization, and we believe there is a complementary role for both.

While a number of problems have surfaced in the last few years, SIFMA’s task force believes the appropriate approach is to fix what is broken, and bolster what worked. It does not make sense to discard products, services, and market practices that were demonstrably sound and beneficial to mortgage finance markets.

With respect to private securitization markets, industry participants are working to develop transactions that are palatable to both issuers and investors. This process will take time, and will require a meeting of the minds between and among issuers, underwriters, and the investors who buy their products. Recently we have seen the first RMBS transaction supported by new-issue loans. While this was but one transaction, it is at the least a promising sign that private mortgage securitization is not dead. We believe that significant time and work is in front of the industry before the private markets may be declared healthy, and it is important in the interim that the government not take actions that will preclude or otherwise significantly harm progress towards the restoration of vibrant private RMBS markets.

Some specific considerations for the GSEs follow.

*The Specific Form of Corporate Organization, and Securities Issuance, by the Successor(s) to the GSEs is Flexible, as Long As It Provides for Homogeneity in Secondary Markets*

The TBA market is based on one fundamental assumption – homogeneity. TBA trading is based on the assumption that the specific mortgage pools which will be delivered are fungible, and thus do not need to be explicitly known at the time a trade is initiated. At a high level, one pool is considered to be interchangeable with another pool. What this means for securities issued by any future GSE or successor entity or program is that regardless of how they are organized, or how many there are, the securities must look the same from the perspective of an investor. They should share the same guarantee, the same terms (payment day delay, etc...), and be for all intents and purposes fungible.

*A Security Issuer Modeled After Ginnie Mae?*

One option for securities issuance is to create a single entity that issues securities, modeled on GNMA (or, with appropriate staffing and resource and technology increases, presumably it could be GNMA). Regardless of how many GSEs are created, or even if any are created, one entity would issue the government guaranteed debt. This would provide for homogeneity and would minimize duplication of efforts on the part of multiple GSEs. SIFMA’s Task Force would support such an outcome.

*How Many GSEs?*

If one entity is established to securitize loans, then questions of the appropriate number of GSEs becomes somewhat (but not entirely) less important, in the context of the maintenance of homogeneity in their MBS issuances. It is sometimes suggested that there should be more than two GSE-like entities in order to minimize systemic risk and “too big to fail” problems that are faced today, and on the surface, this would seem to be accomplished by creating five, six, seven or more GSEs. However, we note that each GSE will be placing the same “bet” on the housing markets, and thus the total risk across the system would not be reduced. Further, any future GSE is likely to be more strictly regulated and its activities more circumscribed or described alternately, less diversified. Thus the multiple GSEs would be significantly similar in terms of their activities, assets, and risk profiles. In the event of another significant downturn, the correlation between them will likely be 100%. Certain of these risks may be mitigated by a careful drawing of the boundaries of the activities of the entities in terms of products, activities, and risk limits, but recent experience has shown that unexpected events can devastate the most carefully

constructed risk management plans. Thus, while the creation of multiple GSE-like entities could result in no single “too big to fail” entity, the risk of a systemic failure will still be present.

Furthermore, if the securities issued by the multiple entities were not sufficiently homogeneous in the eyes of investors, they would trade in separate TBA markets with reduced liquidity and higher interest rates for mortgage borrowers. An important factor for liquidity in these markets is the size of the market – that is, the available supply and new production of products for a given issuer, coupon, and term. Estimates vary on what is the minimum level of “tradable float” for a given product at the security coupon level, but it is safe to say that it is in the multiple tens of billions of dollars and most likely exceeds \$50 billion per coupon (e.g., a liquid market in TBA eligible FNMA 5.5% coupon MBS would require at a minimum \$50 billion of outstanding, tradable securities). Right now, there are distinct TBA markets for Fannie Mae and Freddie Mac securities, divided into the term (15 vs. 30 years) and further segmented by coupon. As the number of GSEs is increased, the number of TBA markets that will need to be supported by market makers and investors will increase ultimately reaching a point where fragmentation and operational complexity negatively impacts liquidity. Also working against liquidity will be the fact that the tradable supply in each distinct market will get smaller as more GSEs become issuers of MBS. Thus, policymakers must be sensitive to the need for significant issuance of homogeneous securities into a limited number of distinct markets to ensure liquidity. If the securities issued by multiple GSEs are not homogeneous, then liquidity will be impaired to the detriment of mortgage borrowers.

On the other hand SIFMA members do believe there is an important benefit to having more than one GSE. This benefit is not so much in terms of competition in terms of prices, products, or profits, which is the usual rationale for desiring a multiplicity of participants in a market (and which played a role in the demise of the current GSEs – especially competition with the private MBS markets). Rather, it is competition in terms of responsiveness to originators and investors. If only one GSE is created, what incentive will it have to be responsive to the needs of its originators? Originators will not have an alternative. Maintaining at least two entities would thus provide incentives for the GSEs to be responsive to their originator clients, and also to the needs of investors, for they would have to face a risk of losing business to the other. Given the considerable expertise and experience of the professional staff of both GSEs, it may be advisable to keep the current infrastructure as intact as is reasonable while still accomplishing the desired policy and reform goals. A strong regulator, as discussed below, would be needed in order to monitor the activities of the GSEs and ensure that this responsiveness does not turn into a repeat of a competitive “race to the bottom” similar to that which was experienced in the previous decade.

#### *Portfolios Present a Number of Issues, But Ultimately At Least A Limited Operation Portfolio Is Needed*

SIFMA task force members agree on an important overarching premise regarding portfolios – if they exist, whatever form portfolios take will require a clear mandate. One thing that is clear in the aftermath of the last two years is that inappropriate management the risk of the portfolios contributed to the inability of the GSEs to support the housing markets when their support was most needed.

#### *Transactional Portfolios Are Needed To Keep MBS Markets Liquid and Provide Flexibility to Originators*

Our members agree portfolios will be required if for nothing else but to facilitate securitization and standard maintenance of securities issuance programs, such as providing a holding facility for loans that are repurchased from securitized pools. Even if the GSEs or successor entity themselves do not issue MBS (i.e., it is issued by a GNMA-like entity), one would assume that the future GSE or successor entity would be the parties responsible for repurchasing delinquent, modified, or otherwise non-qualifying loans from securities. Furthermore, the GSEs currently provide to originators the ability to sell loans on a flow basis, that is, as they are originated, to the GSEs. The GSEs serve as an aggregator, and collect loans until a critical mass is reached and MBS can be issued. Further, portfolios also served a function of intermediating prepayment risk for smaller institutions that may not have had either the size or ability to economically manage such risks on their own. If GSEs were unable to provide these functions, smaller originators may have problems managing such risk, issuing MBS on their own due to warehousing costs

and other issues, and they would be forced to sell their loans to a larger institution (a competitor) that could support a large portfolio of loans. This would likely have a negative impact on the pricing of their lending products to consumers. If portfolio activities were limited to serving this role, they could be capped at levels significantly lower than their current size and significantly mitigate current concerns around systemic risk they present.

However, some SIFMA members believe that the portfolios should serve a somewhat broader purpose than simply facilitating securitization of single-family mortgages.

#### *Multifamily Lending has Generally Been a Portfolio Product*

The GSEs have traditionally played an important role supporting multifamily lending programs, especially through their retained portfolios<sup>3</sup>. While these programs are smaller than the traditional single family business, they are no less important to many homeowners and renters. However, the multifamily markets have not lent themselves to supporting a liquid MBS market akin to that of single family products to this point. One reason is because the collateral is less homogeneous and more concentrated, and another is simply due to the size of the markets compared to single family – they are much smaller. Thus, the GSE portfolios have played a very important role in supporting multifamily lending, and if this support is withdrawn it is not clear what will provide needed liquidity to multifamily lenders. Task force members note, however, that if successors to the GSEs were to issue multifamily MBS that were government guaranteed, there would be a market for it. The policy question is whether or not this market would provide pricing that enabled the desired amount of multifamily finance. Whether or not the GSEs have portfolios, SIFMA members believe that multifamily activities should remain within the scope of acceptable activities for GSEs or successor entity in the future. We do not believe that multifamily markets will operate efficiently without this support.

#### *Historic Role of the Portfolios, and the Question of the Need for a MBS Market Backstop*

Prior to 2008, the GSE portfolios played an important role as a kind of backstop or source of liquidity of last resort for their MBS markets, providing demand in areas where demand was weak. In this case, the profit motive of the GSEs incited them to buy their own MBS when it was “cheap”. This activity mitigated volatility, serving to keep mortgage interest rates more stable. Given this past role, many SIFMA task force members believe that in the future portfolios can and should play an important role as a countercyclical buffer, stepping in to create stability in mortgage markets when private investor demand is weaker. Due to the GSEs’ difficulties, the Federal Reserve played this role throughout 2009, although to an extreme far beyond the traditional role of the GSEs.<sup>4</sup> Many members of the SIFMA task force believe that the GSEs or successor entities should retain portfolio functions for these purposes, but limited to activities with respect to conforming products. Furthermore, many task force members believe it is appropriate for any portfolio functions beyond an operational portfolio supporting the guarantee business to be housed in a separate entity or otherwise completely walled off from the guarantee business.

A challenge with this approach relates to the motivation for GSE or successor entity to play this role. As noted above, in the past the profit motive of the GSEs provided incentives to purchase “cheap” securities in the secondary market. However, the downside of this profit motive was that the GSEs arguably did not have incentives to shrink the portfolios in times when they were not necessary to provide stability to the markets. Given that any future GSE or successor entity is likely to have a moderately or extremely

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<sup>3</sup> According to the 2008 FHFA annual report, at the end of 2008 Fannie Mae held \$117 billion of multifamily loans in addition to the outstanding \$38 billion in multifamily-backed MBS. Freddie Mac held approximately \$72 billion in multifamily loans in addition to its \$13.5 billion in outstanding MBS issuances. 2008 FHFA report available here: [http://www.fhfa.gov/webfiles/2335/FHFA\\_ReportToCongress2008508rev.pdf](http://www.fhfa.gov/webfiles/2335/FHFA_ReportToCongress2008508rev.pdf)

<sup>4</sup> The Federal Reserve entered the market with a mandate to push mortgage rates down and increase affordability of mortgage products, as well as to drive investment out of GSE MBS and in to other financial products to support those markets, through what the Fed calls the “portfolio balance channel”. See remarks of Brian Sack, Executive Vice President of the Federal Reserve Bank of New York, available online: <http://www.newyorkfed.org/newsevents/speeches/2009/sac091202.html>

reduced motivation and/or ability to earn unlimited profits, it is somewhat unclear what would incent the GSE or successor entity to purchase securities in this manner. That being said, there may be a nexus between this portfolio function and guarantee fees charged by the GSEs, in that, if a GSE were organized as a utility or otherwise with strict ROE or earnings targets, when portfolio profits were higher, guarantee fees charged by the entity could be reduced, and when portfolio profits were lower, guarantee fees could be increased. This would create incentives for portfolios to shrink in times when MBS were not “cheap” and providing sufficient returns. However, it is unclear if such a portfolio would be able to attract the level of talented professionals that would be required to manage such an important function.

Assuming the GSEs were allowed to play this role, appropriate maximum sizes for the portfolios could be implemented if desired. This number would likely be somewhere above zero but significantly smaller than the current \$900 BN cap faced by each GSE. The maximum size should be clearly related to the capital of the institution and the overall size of the mortgage markets. Should the markets require support above and beyond the capacity of these limited portfolios, it is likely that the nation would be facing another financial or economic crisis that would make direct, explicit government intervention in all likelihood necessary. Regardless of the ultimate level of the cap, graduated capital standards may be appropriate in order to incent appropriate risk management as the portfolios grow.

Significant challenges exist, however, to creating portfolios that are able to expand quickly from de minimis levels to larger sizes to provide support to mortgage markets. Presumably the GSEs or successor entity will need to issue debt to support a portfolio expansion (discussed further below). However, if there is not a significant supply of outstanding debt, liquidity for new issuances and the market's capacity to absorb significant quantities of securities will be limited. Therefore the ability of the GSEs or their successors to provide support may be limited by (a) the absolute amount of debt they are able to issue in a short period of time, and/or (b) the cost of the debt issuances. Thus, if portfolios are expected to fill this role of a balance sheet of last resort, they will need to have a steady state level that provides enough liquidity so that their sizes can be increased quickly in case of emergency.

Ultimately the question of whether or not a backstop bid is required for MBS markets is a policy choice. While a portfolio that played this role could have the effect of smoothing out volatility, it is important to keep in mind that some degree of volatility is normal for a financial market. It can also be argued that if the GSEs or their successors effectively and consistently transmitted investment capital from investors in MBS to the banks that make loans to borrowers that this by its very nature would have the effect of smoothing out volatility in mortgage rate, and that their portfolios are not needed for this process to take place. The smoothness that is obtained may not be to the same level as if they were also actors with portfolios, but questions of the socially desirable level of mortgage rate volatility are not questions for markets, but rather policymakers.

#### *Larger Policy Questions Regarding Portfolios*

The issue of portfolios raises a relevant policy question – if the portfolios are meant to serve a public policy purpose (stability in the mortgage markets/balance sheet of last resort), should they be housed within an official arm of the government (such as the Treasury) or reside in private or semi-private markets? One major difference between the past portfolio activities of the GSEs when compared to the Federal Reserve's effort is that, generally speaking, the GSEs acted with economic motivations with respect to their own MBS, and other market participants were better able to discern why the GSEs acted as they did, and have a better window into where these large, important players may next act. In contrast, the actions of the Federal Reserve have stemmed from a macroeconomic policy goal as opposed to a relative value, profit motivated goal, and have caused market distortions due to their unique nature. If the portfolio is housed within a government entity, it could have an appearance of being a price targeting mechanism, and be considered to be more likely to act with non-economic motivations that could lead to distortions of the market. Ultimately, a portfolio that did not act in accordance with economic principles could lead to meaningful distortions of the MBS market.

Most of the task force members believe GSEs or their successor entities should be prohibited from purchasing anything other than their own conforming MBS. However, some task force members



strongly believe that if properly managed, retained portfolios including non-conforming assets would serve an important function commensurate with broader policy goals. This view is based on a premise that portfolios are not inherently bad, but rather that mismanagement of risk caused the problems we are now dealing with. These members note that the GSEs could serve as providers of seed capital to small or new markets that have not yet developed strong liquidity on their own.

All in all, the task force members believe a retained portfolio in some form is necessary on a purely operational basis, at a minimum. Beyond this level of activity, policy choices must be made regarding the role that a portfolio could play in mortgage markets. A portfolio could have a special role in multifamily markets; and if policymakers determine that smoothing out significant volatility and liquidity disruptions is a policy goal, a portfolio housed either in a GSE-like entity or an agency of the government would be a means to accomplish that goal.

#### *Considerations for GSE Corporate Debt*

Task force members agree that if the GSEs or successor entities maintain portfolios of any significant size, such portfolios will need to be financed, and this most logically will come through the issuance of corporate debt. This raises the question of whether such corporate debt should carry some form of a government guarantee like that proposed for MBS as previously discussed.

Some task force members believe it might be difficult for the GSEs or successor entities to issue non-guaranteed debt in significant volumes, if at all, in times of financial or economic stress. One solution to this problem might be to establish a permanent financing facility for the GSEs within the Treasury Department or the Department of Housing and Urban Development. On the other hand, GSEs that issue guaranteed debt will achieve a funding advantage over non-GSE market participants. It is conceivable that these competitive issues could be addressed through regulation; in any case issues around the corporate debt of the entities need to be considered in more detail. They are not, however, directly related to the issues which are central to this document, those being liquidity and capital formation for mortgage markets. We also note that to the extent that the GSEs are limited to owning government guaranteed MBS, this would likely confer benefits to their debt issuances, as they would be perceived as safer.

#### *Transition Issues and Resolution of the Conservatorships*

##### *-Guarantee Needed For Existing Securities*

SIFMA Task Force members believe the government must clearly state intentions with respect to legacy GSE issues prior to and during any transition, and that existing GSE MBS and corporate debt should be explicitly guaranteed. Bifurcation of markets into pre- and post-reform markets should be avoided at all costs. Especially for the MBS, considerations of bridging the assets from the 'old' market into the 'new' market will arise. Exchange programs for existing assets could be arranged in the event that terms of securities under the new regime materially differ from terms of existing securities. These exchange programs have been executed in these markets in the past, and lessons learned from those experiences can guide future operations.

##### *-Creation of a Wind-Down Vehicle*

In terms of addressing issues with delinquent, poorly performing, or non-conforming assets held by the GSEs, SIFMA Task Force members are in general agreement that existing "bad" assets should be spun off into a wind-down vehicle (i.e., assets split into a good bank/bad bank arrangement). Determining the structure of the vehicle involves tradeoffs: Both existing GSEs could become wind-down vehicles (or merged into a single vehicle) and new activities carried out in a new entity. This would provide the benefit of nominally providing a "fresh start" and allowing policymakers to "eliminate" Fannie Mae and Freddie Mac, which could confer some benefits. On the other hand, seemingly simple things like name changes of the enterprises will present significant operational challenges for investors in terms of requirements for

new investment committee approvals, documentation, IT systems, and other similar issues. Therefore it may be easier to simply create a new entity and transfer the bad assets into that entity.

*-The Challenge Is To Determine What Is “Good” And What Is “Bad”*

Non-agency assets held in the retained portfolios of the current GSEs may be easily identified and placed into the wind-down vehicle. SIFMA Task Force members believe that loans held in the existing portfolios should also be placed into the wind down vehicle. Many existing Agency MBS securities held in portfolio, however, are composed of good and bad assets.

One option for these existing securities would be to place bad loans bought out of securities into the bad bank as they are repurchased. However this would involve some degree of operational complexity and inefficiency. Therefore it may be advisable to place all existing portfolio holdings into the wind-down vehicles. If some of the wind-down vehicle's assets perform well, that will only serve to reduce the ultimate costs of the wind down process. Additionally, assets in the bad bank need the same transparency or better than they have now as they will be an excellent source of market information.

Our members have reached a general consensus that the easiest and most efficient way to separate assets is to draw a clear line on the date when the GSEs are reorganized. Assets held by the GSEs before that time would be placed in the bad bank, and assets created after that time would be placed in the good bank. If there is a policy goal to retain assets in the new companies to the extent possible, then only non-conforming assets (by the new definition of non-conforming, whatever that may be) could be moved into the wind-down vehicle.

*Policymakers Must Provide for a Strong Regulator and Strong Capital Adequacy Standards, And Define a Clear Mission for Successors to the GSEs*

It is clear that due to poor risk management, flawed business strategy and other management and policy failures, the GSEs became insolvent. Part of the blame for this can appropriately be ascribed to the fact that the GSE's former regulator, OFHEO, lacked certain powers that were appropriate for its role such as the ability to freely adjust risk based capital standards, better regulate the management and activities of the GSEs, and place the entities into a conservatorship as opposed to receivership, if needed. This has been at least somewhat rectified since 2008 with the creation of FHFA. Going forward, any GSE must continue to be regulated by a strong, empowered regulator with the powers to disallow practices that have become too risky, enforce appropriate capital standards, and to reign in competitive excesses that threaten the stability of the organizations. For this to be possible, the regulator must be sufficiently funded so that it is able to develop a staff with the requisite expertise and experience to manage such an important role. Presumably fees on government reinsurance could fund the regulator. In any case, it will be important to market participants that the future entities, if they exist, are properly regulated as to avoid a repeat of recent history.

## **5. How should the housing finance system support sound market practices?**

- ***Commentary could address underwriting standards; how best to balance risk and access; and extent to which housing finance systems that reference certain standards and mortgage products contribute to this objective.***

*Bad Underwriting is at the Center of Market Disruption and Key to Future Success*

At the center of the recent market distress lies bad underwriting. The crisis spun out of control because of the pervasiveness of poorly performing products; poorly performing products became so pervasive because relaxed underwriting standards allowed volumes of loan origination to expand to unsustainable levels.

While many reforms have been proposed, suggested, and/or implemented, the most effective check on future excesses would be regulation of mortgage underwriting that requires that lending be sensible and based on some reasonable expectation of repayment. Of course, a balance needs to be struck between access to credit and assurance of repayment, as it is unreasonable to expect that each and every borrower will repay his or her loan. But the bottom line is that attempting to regulate primary lending markets through regulation of securitization and other secondary markets is by definition inefficient, will cause distortions, and will be likely to see only uneven success. We note that while improvements to underwriting can help lead to a safer system, they will not entirely eliminate systemic risk. The system will still be vulnerable to exogenous shocks, however, it should have a more solid base of support to withstand such events.

The GSEs traditionally have been a reference point for origination standards. They also, as discussed above, have fostered the development of beneficial products such as 30 year mortgages, and standardized documentation.

Some thoughts on the role of underwriting standards and the future of the GSEs follow.

*Role for Government and the Regulator in Setting Underwriting and Risk Management Standards for GSEs and any Successor Entities*

The GSEs were established with a clear public policy goal of providing a stable source of funding for the mortgage market and thus mortgage availability and affordability for homebuyers. Arguably the GSEs got into trouble when they strayed beyond their original mission whether by their choice or because of policies that incited the GSEs to stray. It seems appropriate that an explicit government guarantee, such as what we have suggested above, should be matched with an explicitly defined mission specifically as it relates to product and credit parameters. We believe it is appropriate for policymakers to make decisions regarding what mortgage products should be the beneficiaries of government support. It is also appropriate for the government, if it offers a guarantee, to set out in a broad manner uniform underwriting standards that appropriately balance the availability of credit to deserving borrowers and the risk they present to the government insurance program. Historically, SIFMA has supported efforts of legislators to develop uniform regulations and laws regarding mortgage lending; by regulating the activities of the conduits of the majority of mortgage lending, a similar purpose may be achieved through a more appropriately market-based mechanism. In other words, if policymakers have a view as to what is the most beneficial form of mortgage lending, that can be the area in which the GSEs or their successors operate. Lending products that fall outside of that area will be forced to stand on their own, and attract investment capital through their own merits and performance.

That being said, our task force members believe that there are sound market efficiency reasons to preserve the ability of the GSEs or their successor entities to implement specific policies and criteria, such as risk-based pricing or underwriting guidelines, within broader parameters outlined by Congress and their regulator. We note that FHA has struggled to implement risk based pricing for its program, which has resulted in negative consequences for the performance of FHA's insurance fund.

This limited flexibility would allow the GSEs to react to changing market conditions, and with an appropriate risk management infrastructure in place, provide an efficient service to the economy.

**6. What is the best way for the housing finance system to help ensure consumers are protected from unfair, abusive or deceptive practices?**

- ***Commentary could address: level of consumer protections and limitation; supervising agencies; specific restrictions; and role of consumer education***

The best protection for consumers will be the development and maintenance of sound underwriting principles. We note that while many policy efforts have aimed at the secondary markets, such as risk retention, assignee liability, or otherwise, the most impactful, direct, efficient, and effective means to

regulate lending standards is by actually regulating lending standard. The answer is not to use the secondary market as a policeman for primary markets; rather, primary markets need direct attention. Furthermore, the market values of loans and mortgage-backed securities are determined by the integrity of the origination process – this is aligned with the interests of mortgage borrowers.

## **7. Do housing finance systems in other countries offer insights that can help inform US reform choices?**

SIFMA’s task force acknowledges that other countries have developed mortgage finance systems that have been successful and resilient through the recent market disruptions – Canada and Denmark are commonly noted. While we agree that these arrangements have worked for these countries, these models are not “the answer” to issues faced by the U.S. We do believe that policymakers should look to what has worked for these countries and if, and how, it could be applied to the U.S. However we do not believe a broad-brush general application of the foreign systems can be simply transferred to the U.S.

As a general matter, we note that both Canada and Denmark’s mortgage markets are fractions of the size of the market in the U.S. and are significantly more homogeneous and geographically concentrated. They are likely not scalable to the size of the U.S. markets. We also note that in many other countries, fixed rate mortgages are not predominant. The unique characteristics of the U.S. economy, geography, and populace have led to the development of a mortgage finance system that is customized to its needs. While a number of problems have become painfully apparent in the last few years, our Task Force does not believe it is appropriate to discard the fundamental underpinnings of the system and attempt a wholesale importation of a foreign country’s policies. Each of these other countries have likewise developed a mortgage finance system customized to their needs; importing the U.S. model there would be similarly unlikely to succeed.

As discussed above, we believe that ultimately the best approach to the U.S. mortgage market should be focused on the U.S. mortgage market, and central to that focus is to ensure that underwriting policies and practices are robust and promote sound lending.

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