October 31, 2013

Dear Chairman Johnson and Ranking Member Crapo,

The Securities Industry and Financial Markets Association (SIFMA)[1] and our member firms appreciate the opportunity to provide our views to you and your staff regarding the Committee's efforts to reform the housing finance system. The sheer number of questions posed by the Committee are evidence of the complexity of our mortgage finance system and the importance of getting things right. We believe the resolution of the current conservatorships and the development of the new model for housing finance form one of the most important set of issues facing Congress and the nation today. While SIFMA and its members have opinions and priorities for how the new housing finance should be structured, we also want to serve as a resource for the Committee.

S.1217 provides one blueprint for reform and we have previously commended the authors on their thoughtful approach. Notably, S.1217 would provide some flexibility in its regulatory construction. It would allow for both a guarantor- and securities-based approach to how private capital would support the new conforming loan market, and presumably for a hybrid model approach combining elements of both options. There are many important details that need to be resolved and we strongly support the work of this Committee and Congress to provide that clarity. As this effort proceeds and new issues arise, we look forward to providing additional comments and suggestions.

It is our belief that Congress intends to maintain access to the 30-year fixed-rate, prepayable mortgage product. To that end the most important component of S.1217 is its establishment of an explicit government guarantee for the new conforming loan market. This guarantee is essential for the existence of a liquid TBA market and for the significant benefits this market provides to borrowers. SIFMA members believe this market is the most important aspect of the current system. However, the government guarantee is not the only requirement to preserve a vibrant TBA market, as we discuss below.

SIFMA members believe a critical issue that will require further study and refinement will be the mechanics of exactly how continuity of liquidity will be maintained as we transition the market from the current system to the new system. While we cannot overstate the importance of ensuring liquidity will be maintained, it is also difficult at this time to provide comprehensive guidance on how to best do so until more of the structural foundations of the new system are known.

Set forth below are SIFMA's views on a number of the questions posed by the Committee. Please do not hesitate to contact us with questions or for more information.

Sincerely,

Kenneth E. Bentsen, Jr.
President, SIFMA

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[1] 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.

Guarantee

1. ***How much private capital should stand in front of the government? Are there sufficient mechanisms in place to verify that the first loss position has been met? If not, what other structures could protect taxpayers while providing a well-functioning mortgage market? Should the percentage or number be established in statute or by the regulator?***

2. ***Under what circumstances would the government provide funds for principal and interest associated with covered securities? When a certain percentage of private capital on a particular mortgage-backed security (MBS) has been exhausted? Only after a private guarantor is resolved? What percentage of the principal and interest payments of a qualifying MBS should be guaranteed by the government?***

3. ***How does first-loss capital interact with any insurance fund where a guarantee fee is being charged up front for the backstop?***

The questions assume that neither fully private nor fully government (*i.e.,* no-risk sharing) options are viable, but we believe the unique benefits of these two extremes should be kept in mind simply as a point of reference. Specifically, a fully government-supported market offers the lowest cost of capital, best controls systemic risk and creates a system with the greatest product standardization; while a fully private market offers the greatest operational efficiencies, maximum market competition (product innovation, price competition, etc) and the least opportunity for politics to overwhelm market forces.

The reality is that the system will operate in between those extremes. We believe it must operate in the following manner to support a liquid TBA market: the end investor must know that all expected funds will be paid at the time they are expected to be paid. This includes advances of principal and interest (see our answer to question 38), and the ultimate government guarantee against credit loss on the mortgage pool. The receipt of these funds cannot be delayed until the outcome of a resolution exercise or contingent upon other factors. Anything else will disrupt the liquidity of the TBA market, because it will convert what is now a credit-risk free investment into a product with an element of credit risk. This will drive away some rates investors who will only invest in assets without credit risk, and will require mortgage lending to be funded by credit risk investors, who will require significantly higher returns compared to rates investors.

Guarantor and Securities-Based Loss Sharing Arrangements

There are two overarching points relative to this discussion which should not be controversial. First, the risks in this market are extremely correlated, as we saw in the 2006-2009 period. This means that it is very likely that if one entity is experiencing a solvency issue, it is likely that many other entities are, or will soon be in a similar position. Second, the market should be able to function through a period of disruption and continue to provide mortgage credit.

Given the importance of the housing finance system and how deeply intertwined it is with the broader economy, the government will not be able to ignore a breakdown in this market. Providing a catastrophic guarantee is vital, but not sufficient. The design of the new system must include a robust plan for replacing failed loss coverage providers and identifying new sources of first-loss capital in a crisis. Otherwise, the government may once again face the choice of supporting failing entities or allowing the housing markets to collapse.

One possibility to support this approach while minimizing disruption would be to adopt a system that includes a resolution process that is similar in nature to the resolution process in the banking system. The work being done by the FDIC in implementing Title II of the Dodd-Frank Act could provide a useful reference for how this could be done. The regulator of this system would utilize powers modeled on bank

regulators' ability to require prompt corrective action in advance of any resolution in order to try to avoid its occurrence, including steps to restore capital levels. If resolution were necessary, an institution would be placed into a receivership while remaining a functional entity (*i.e.,* a "going concern"). The operating company would continue to function, while any losses from a receivership would be allocated to private investors and the entity sold to new owners. Any unallocated losses borne through the resolution process could then be recovered through future FMIC assessments on all guarantors.

Without some form of a resolution mechanism like the model discussed above, the system runs the risk that multiple guarantors concurrently become undercapitalized and are not able to write new business given the fact that the risk they deal in is highly correlated. This would likely be a bad outcome for credit availability. While the government guarantee provides support for holders of existing securities, it is equally important that there remain functional entities to provide the first-loss coverage needed for new securities that support continued mortgage origination in a period of market stress.

In the context of securities-based arrangements where capital markets investors take first-loss credit risk, to ensure credit availability through a cycle, the required level of loss sharing needs to be flexible to accommodate periods where market appetite for credit risk is weak. An immutable level of risk sharing would exacerbate the naturally pro-cyclical nature of mortgage lending – if there were housing market distress, risk would be more expensive to sell, and that would increase the cost of credit. Increases in the cost of credit would exacerbate housing market distress, and so on. This is not to say that it is inappropriate for mortgage rates to fluctuate due to economic or other factors, but rather that it is appropriate for policymakers to have levers to ease extreme periods of dislocation before they become systemic problems. Importantly, significant changes in the pricing of the loss-sharing transactions will signal to regulators and policymakers that a disruption in the mortgage markets warrants attention.

Activation of Government Loss Protection

SIFMA members do not believe the specific level of private capital required to stand in front of the government guarantee should be specified in statute. We believe that this decision should be left to the regulator of the new system. A regulator will be able to conduct market analysis utilizing its own staff and expert consultants, examine the performance of the existing GSE risk sharing transactions, study the risk presented by the mortgage loans that will be eligible for the new system (*i.e.,* determine risk sharing requirements in relation to the new conforming market's 'credit box'), and develop an econometrically appropriate private-sector loss absorption arrangement. Additionally, this approach would be similar to how bank capital requirements are set, and would allow for mitigation of any arbitrage opportunities that could be created by differences in the bank and new conforming market regimes. Furthermore, this analysis would be able to be made concurrently with the implementation of the new regime – not many years in advance, without foreknowledge of market developments in this time.[2] The balance to be struck is between greater protection for the taxpayer and the cost for mortgage borrowers.

Private capital tends to be better able to price the cost of credit losses. However, private capital is less able to bear the cost of extreme losses and incapable of maintaining credit availability in a systematic failure. Therefore it is a less efficient provider of price discovery for tail losses and should not be used to price out all credit risk. We note that the pricing of AAA assets mainly concerns the cost of market liquidity and should not be considered an estimate of market expectations for the cost of tail credit risk. The question is: at what level of risk sharing does the market most benefit from private capital's superior pricing discipline for more normal risks while also maximizing the efficiencies that only the government can offer in extreme scenarios?

[2] The GSEs' minimum capital levels were established in statute, and couldn't have contemplated the complexity of the market's development or the environment they encountered. The regulator put buffers on top of the statutory minimums. We believe the best approach is to leave the capital requirements to the regulator in total.

An inherent drawback of private capital from the perspective of affordable credit is that it requires a reasonable risk adjusted rate of return to attract and retain investors. For example, some proposals for private coverage devote nearly three quarters of the premium to return on equity in order to generate relatively modest returns (*e.g.* 37.5 basis points of a 50 basis point guarantee fee would go to pay returns to equity holders). A fully private system operating without a guarantee would be highly capital intensive and would require insurers to maintain large cash reserves against losses. A government guaranty, in contrast, requires less risk-absorbing capital to be raised by the private sector (but would require budgetary reserves and the buildup of a reserve fund from users of the system, if one is included) and can be run at break-even pricing if the taxpayer receives no return and the benefits are passed along to the borrower; therefore, deeper government coverage should lower the cost to the borrower, and vice versa.

This favors a system where normal losses are absorbed by a private for-profit enterprise, while extraordinary losses would cause a draw on a government guaranty financed through the collection of guaranty fees.[3] There is an inherent tension: the greater the risk taken and the greater the amount of capital required to be raised from private-sector actors, the greater the required return necessary to attract private capital. However, tighter regulation limits the ability to provide greater returns.

We have not, in this discussion, specified a specific attachment point for the government's extraordinary loss protection. This is because the calculation of this figure will be a very complex and assumptions-specific exercise, involving the factors we discuss above and more. We believe this is a task best mandated to the regulator of the new system, who would be given appropriate funding, political independence, and organizational structure to appropriately manage this analysis.

Number of Guarantors

Advantages to a system with greater numbers of first-loss credit providers may include: (1) the ability to optimize execution among competing pricing and eligibility criteria, (2) insulation from operational failure of any single first-loss credit provider, (3) greater variety and more innovation in product offerings and (4) more equal bargaining strength between first-loss credit provider and mortgage originator.

On the other hand, a system with fewer first-loss credit providers (or even a single provider) may offer increased product standardization (and, hence, easier loan fulfillment), enhanced liquidity for both loans and securities, lower total cost of infrastructure, and less burden on the regulator overseeing each of these institutions. Finally, it is important to note that it is primarily systemic risk, as opposed to individual business decisions, that will drag down these institutions due to the extreme correlation of their business models. Therefore the perceived benefits of risk diversification gained from increasing the number of first-loss credit providers may be somewhat illusory.

Many of the benefits of a system with greater numbers of first-loss credit providers carry the risk that they could be exploited by sellers for arbitrage opportunities created by differences of viewpoints between the various first-loss credit providers. Such opportunities may represent mispricing of risk and could heighten the likelihood of market dislocations. Additionally, some of these advantages may be illusory because a more efficient and standardized market might more than make up for the benefits of execution optimization by offering better aggregate execution on all loans and greater market stability.

Finally, competition among first-loss credit providers creates a risk of a "race to the bottom" in pricing and guideline offerings. A similar issue also arises in Co-Op structures where members may attempt to gain market share or increase margins by making riskier loans and "free riding" by delivering them into the Co-Op's pricing, which is based on aggregate collateral performance.

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[3] A loan-level guaranty fee is another form of private capital buffering the exposure of the taxpayer, in addition to any capital markets or guarantor exposure to credit risk.

All of this argues for a focused effort to ensure that healthy competition is promoted among guarantors and other parties. Barriers to entry should be limited to the level that is necessary to ensure a stable environment and regulatory standards should be high enough to ensure that incentives to "race to the bottom" are mitigated. We believe this also argues for a market-determined number of first-loss credit providers, not the chartering of a specific number of entities determined by statute.

4. ***How will different forms of first-loss private capital — including capital market and mortgage insurance structures — impact the homogeneity that the current guarantee provides? Is this compatible with the To-Be-Announced (TBA) market? If not, what are the potential impacts to mortgage credit accessibility, affordability and liquidity? How will that interaction impact the availability and pricing of mortgage credit?***

The most important factor in considering how first loss capital could be introduced into the markets for guaranteed MBS is whether or not a particular approach will disrupt the critically important liquidity of the TBA market. The TBA market was the only secondary mortgage market that continued to function during the recent crisis providing a critical backstop role for all mortgage lending.

Many proposals have treated securities-based and issuer-based models as viable stand-alone alternatives. We believe, however, that well-capitalized intermediaries/issuers are likely to be an unavoidable requirement of a viable housing finance system and could work together with securities-based approaches. SIFMA believes that credit risk will at times need to be warehoused to promote an efficient and stable mortgage system; this requires a well-capitalized party to hold that risk in the interim. The key unresolved question is where this credit risk warehousing should occur in relation to the taxpayer – should it be the new FMIC itself, who would oversee the distribution of first-loss credit risk to the capital markets and insurers? Or should it be a privately owned, privately capitalized entity that stands separately in front of the FMIC in terms of loss absorption? The answer to that question drives many of the additional decisions that need to be made.

Some securities-based proposals involve a requirement that risk be shared with capital markets investors concurrently, or near concurrently, with the obtaining of a government guarantee. One of the crucial benefits of today's TBA market is the ability for a lender to lock in a borrower's rate 60 to 90 days in advance at a low (or no) cost to the borrower. This is possible because the loan may be sold on a forward basis into a TBA market that provides a price certain to the lender.[4] To the extent that obtaining a government guarantee is conditioned upon the prior sale of risk into private markets, price information on the credit-risk component of the transaction will not be available to the lender as there is no liquid forward market for mortgage credit risk. This will make it harder if not impossible for lenders to provide no-cost rate locks to borrowers because the cost of the risk sharing is a factor in the pricing of the loan. This could also cause significant problems for the liquidity of the TBA market, and could potentially cause it not to function. This would have a significantly negative impact on mortgage rates and credit availability as many lenders depend on the TBA market for their primary business. Risk sharing requirements would be better structured if they are not an absolute concurrent mandate to achieve the issuance of a new guaranteed MBS – risk may need to be warehoused somewhere for a period of time.

The liquidity of the current GSE MBS markets must be carried into the new market; this $4 trillion market cannot be orphaned in the transition. Abandoning outstanding securities would immediately diminish liquidity and value in the market for existing GSE MBS and would severely damage the confidence of investors in the merits of investing in the new securities. It would also mean that the market for the new form of guaranteed MBS would start with zero liquidity – it would be volatile and would not offer attractive pricing to lenders or borrowers. Therefore, the form of the conforming MBS of the future needs to be generally compatible with the form of conforming MBS today, or at least not so different that the current GSE MBS could not be converted into the new form or otherwise made fungible with it.

[4] Ignoring hedging costs

To the extent that capital-markets risk sharing mechanisms implicate security structuring such as in a senior/subordinate arrangement, there is risk that homogeneity would be lost among different structures, and this will cause difficulties in promoting a liquid TBA market. It is more challenging to ensure that these structures are fungible with the existing stock of MBS. That does not mean this structure should be discarded, but it is an important factor to keep in mind.

Capital markets transactions similar to Freddie Mac's STACR or Fannie Mae's CAS series are viewed as the current form of risk sharing that is most compatible with TBA markets. Since these types of transactions do not impact security structure, they do not have an impact on the functioning of the TBA market. However, their performance through a cycle and ease of execution in less favorable market environments has not yet been observed.[5]

Other arrangements that do not alter security structure, such as pool-level mortgage insurance used in Fannie Mae's recently executed transaction, also appear to be compatible with TBA.

5. ***Several proposals, including S. 1217, envision separate issuers and bond guarantors of MBS. What entities would serve as bond guarantors? Should there be a restriction on their other activities? Should there be a safeguard in place to ensure diversity of guarantors in the market? What requirements should be in place to ensure the bond guarantor holds a sufficient amount of capital against the MBS it guarantees? How should bond guarantors be federally regulated if some of the approved entities are insurance companies typically regulated at the state level? What would be the advantages or disadvantages to any particular approach?***

The base case assumption of how S.1217 intends the market to function involves four main categories of participants.

- First, there will be issuers. The common securitization platform could be the sole issuer of the securities along with handling the operational aspects (disclosure, securities administration, etc) of the processes that face investors and originators. The key is the outcome – a homogeneous TBA market where MBS are completely fungible because they are issued under clear and consistent guidelines.
- Second, lenders will be most accurately described as origination, aggregation, and pooling agents in this system.
- Third, capital markets participants and/or guarantors will hold the first-loss credit risk purchased from lenders. One way to think about the role of the platform is that it should handle functions that a lender or guarantor would be willing to have performed by a third party in the context of their private label activity.
- Fourth, FMIC will hold the tail risk in the system and it or another regulator would regulate participants in the system.

Some of these functions could be combined – for example, securities issuance and loan aggregation could be combined in the platform. This, however, would change the nature of the platform, inserting it into a part of the market where it would take on more risk, and need to be capitalized appropriately. To our earlier point, the platform could then also take on a role of managing the distribution of first-loss risk into the capital markets or insurance markets. This will involve certain costs but may also provide important benefits.

[5] There is a related, specific inefficiency that should be remedied in housing finance reform legislation. The CFTC's commodity pool regulations apply to risk-sharing transactions executed with credit-linked notes or other derivatives, which are the most efficient ways to structure these types of transactions. Characterization of the transaction as a commodity pool, and its sponsors as commodity pool operators, requires the sponsors of the transaction to comply with burdensome and not particularly relevant reporting, registration, disclosure, and other requirements which were intended for operators of true commodity pools (i.e., those which invest in true commodity interests such as cotton or grain). The original design of the GSE's recent transactions was in the form of credit-linked notes. Because of these still unresolved issues, the transactions were significantly delayed, and were changed to a less efficient securities-based structure. Legislation should ensure that these types of risk-sharing transactions are exempt from characterization as commodity pools, and that their sponsors are not deemed to be commodity pool operators.

We believe further examination of these baseline structural options is warranted.

6. ***In S.1217, Section 204(e) prohibits entities taking the first loss position from receiving government assistance. Is the prohibition in this section too broad or not? If too broad, how can flexibility be ensured, but still prevent taxpayer money from ending up in the first loss position?***

While we understand and agree with the principle that loss-sharing should be true loss-sharing and not somehow covered by the government, we believe section 204(e) should be struck. It would have the practical outcome of forcing banks to (1) not invest in risk-sharing transactions and (2) be unwilling or unable to make markets in or underwrite such transactions. With a literal read of the language we are left with questions such as: if a state or municipal pension fund buys a first-loss position, would the state or local government that sponsors the pension be prevented from accepting FEMA disaster relief funds or other Federal assistance? This is admittedly an extreme example, but it underscores our concern that these provisions may have as of yet unthought-of consequences.

As far as holdings by banks are concerned, the primary issue is whether or not the bank is appropriately capitalized and regulated. If a bank, for example, holds a single first-loss position, it does not rationally follow that it should be prohibited from any governmental assistance programs (*e.g.,* FDIC insurance coverage or access to the discount window). The default of that institution would not be a consequence of holding that single first-loss position. The potential problems that may arise related to holders of first-loss risk are those of improper capitalization or monitoring of concentrations of risk positions. These are supervisory and regulatory concerns not issues that can be appropriately addressed with a blunt statutory provision that is likely to have consequences far beyond what was intended.

To the extent provisions like this will be included in the legislation, they should be more clearly defined and limited to the first-loss pieces themselves, as opposed to broader restrictions on the institutions that hold them.

Regulatory Structure

8. ***What specific powers should a housing finance regulator have over a new system? Will an entity-level approval process for private market participants be effective? How should the regulator monitor, examine and regulate market participants to ensure they maintain those standards after approval? Should oversight differ by participant type? Should the regulator conduct examinations and have the authority to levy fines?***

The mandate of this regulator should be to ensure the safety and soundness, function, and liquidity of the new conforming market. It should not extend to borrower protection or the activities of participants in the market that occur outside of the new conforming market.

As a general matter, we believe the regulator should be focused on the entities that comprise the new system and the products that enter that system. This would include the securitization platform and associated rules and standards related to activities conducted on and by the platform, such as pooling and servicing standards, underwriting standards, and approval standards for servicers, issuers, insurers, and other parties, as well as various other issues of a contractual nature related to the operation of the platform. The focus would also include guarantor companies that stand in front of the government and take first-loss risk, and the activities of issuers in terms of pooling and securitization of conforming product.

The regulator's mission should not be duplicative of existing regulators such as the CFPB, the prudential banking regulators, HUD or the SEC. The regulator should not be able to set broader mortgage lending, servicing, disclosure, or other standards that apply outside the government market. It should be able to set

standards that relate to access to the government guarantee (in coordination with the regulator of the government guarantee if they are separate entities). Furthermore, to the extent a rule it proposes materially conflicts with a broader rule, such as the CFPB's servicing standards or RESPA, a process should be put in place that ensures coordination among the relevant agencies.

17. ***For a second lien, S.1217 requires obtaining approval from the holder of a first-lien if the combined loan-to-value ratio would exceed 80 percent. Is this appropriate? If not, what is the recommendation to deal with the impact of "silent seconds" on both the borrower and the investor? How specific should the legislation be regarding reps and warranties? What should constitute a breach or defect and what should the process be for identifying a breach? Should there be a required sunset if the borrowers have made payments for a certain number of consecutive months? Should there be a timetable for submitting claims? If so, what should those timelines be? Should the new regulator be the arbiter to determine if loans should be put back? What entity should enforce reps and warranties?***

We presume this question is focused on the new conforming market and does not extend to the purely private markets. In this case, standards will need to be set for these issues and this should be done by the regulator in consultation with market participants and the public, not be established in statute.

Second Liens

Regarding second liens, our members understand the need for the government, as the ultimate holder of risk in this system, to have arrangements that protect its interest as the holder of risk in the first-lien position. As noted, one mechanism to implement this would be a requirement that the second-lien gain approval from first-lien holder. However, we believe that there are practical implementation issues with such a requirement (*e.g.,* would a first-lien holder ever allow a non-affiliated lender to originate a second-lien? What are the consequences of that?). As an alternative, a mechanism could be implemented that limits the CLTV on any first-lien loan. This would allow for a borrower to apply a second lien to a portion of the equity in a property in a rising home price environment, but limit the added risk to the holder of the first-lien risk. We note as well that second-lien lending has typically been regulated at the state level. In any case, the first-lien holder cannot be responsible for any limitations or prohibitions on second liens – they are not in a position to police compliance and should not be required to do so.

We believe this is a complicated issue that will require study of input from the investor community, the lender community, and those who represent the interests of consumers. This is a task that should be mandated to the regulator.

Representations and Warranties

Improvements to the framework for representations and warranties in GSE MBS programs have been made voluntarily by the FHFA. While these have been appreciated as a step in the right direction by seller/servicers, more is needed to restore the confidence of servicers and lenders.

The statute should direct the regulator to create an enhanced framework for representations and warranties between originators and guarantors within the new conforming system that embodies the following principles, which would serve to increase credit availability and promote greater stability and confidence in the market:

- Sunsets of representation and warranty obligations should occur within a reasonable period of time. The vast majority of defaults manifest early within the life of a loan.
- When defects do occur and the guarantee is called upon, there should be an agreed upon process to review those defects with penalties being applied only in the instances where the defects were both

material and directly caused the loss. Thresholds of materiality can be determined upon on a representation by representation basis.

- Those penalties, when deemed appropriate, should be proportionate to the actual loss experienced. Therefore, while repurchase may be an outcome, it should only be the used in the extreme.
- Additionally, a process should be introduced such that material disagreements can be quickly decided through referral to a neutral third party.
- Changes to the representation and warranty framework should be done with consent of all parties involved.

18. ***Section 216 of S. 1217 gives FMIC additional oversight authorities. Could this section be interpreted to give FMIC antitrust and price control powers? What are the specific challenges or benefits that would accompany either interpretation?***

We believe this section can be construed so broadly so as to give the regulator price control powers. While we agree with the spirit of this section – that the regulator should seek to enable competition, competitive pricing, and liquidity – we believe the language is too open-ended as drafted. Regulatory price control power is not compatible with long lasting, vibrant, and liquid markets. Given the importance of housing to our economy, and the political nature of the regulatory appointee process, we believe this could be a dangerous power. As we note above, SIFMA believes the primary mandate of this regulator should be to ensure the continuous functioning of the new conforming mortgage market in a safe and sound manner.

There are a number of existing regulators with oversight authorities for various components of the financial industry – the prudential regulators, the SEC, and HUD, to name a few. There are also regulators focused on competition – the Department of Justice. We do not believe there is a need to reinvent the wheel --- legislation should enshrine this new housing system regulator with a similar suite of powers as other bank regulators.

Consumer Access

27. ***Should there be an explicit duty to serve underserved populations or geographies? If not, how would you ensure that all creditworthy consumers have access to the mortgage market, particularly those in rural areas? How would you ensure that renters at all income levels have access to rental stock in all geographies?***

28. ***How should a new system ensure that many institutions that originate loans can qualify for inclusion in a government guaranteed MBS?***

29. ***Please provide data on how proposals for a new housing finance system, including S. 1217, would affect the affordability of single family homes. You may choose to focus your answer on one proposal or certain provisions therein. Be specific, including estimates of interest rate or fee impact.***

30. ***How should a new housing finance system build on existing programs that address affordability, such as the Housing Trust Fund and Capital Magnet Fund, to ensure they achieve their intended purpose? How could new proposals, like a Market Access Fund, be structured to build on the existing programs?***

SIFMA members support efforts to increase the availability of affordable housing in a manner that promotes the safety and soundness of the broader system. This requires that support for affordable housing be explicit and transparent.

Servicing

31. Should a new housing finance system include servicing standards, either explicitly or in uniform securitization agreements? If so, what standards should be included?

32. If you believe there should be servicing standards, what should be the regulator's role in ensuring compliance? How should the regulator interact with the CFPB and the prudential regulators, including state regulators, given the CFPB servicing rule and regulatory guidance and enforcement actions?

39. How should servicing requirements under a new housing finance system be structured to interact coherently with existing servicing rules and standards? Are there any existing or anticipated rules or standards that conflict?

Servicing of loans is an essential part of mortgage finance, and how loans are serviced has material impact on both borrowers and investors. Uniform standards for servicers in the new conforming system are needed to ensure consistent and predictable performance among different servicers. This will create more predictable MBS performance and encourage a more liquid market.

Any servicing standards applied in a new structure should be consistent with the CFPB's National Servicing Standards that become effective in January 2014, and future CFPB actions and rules should not be able to impact the safety and soundness of the guarantee. Therefore, servicing standards set up by the regulator of the new conforming system should be similar to, and deemed to be compliant with, all applicable servicing regulations.

Limiting the absolute number of entities having oversight of servicing to a manageable number, and coordination mandates to being applicable to all regulators would help ensure regulatory communication, coordination and oversight were maintained at a high but efficient level.

33. Should servicer oversight include "cross default" powers, such as Ginnie Mae's ability to terminate issuer status and rights when a servicer defaults?

We do not support cross-default provisions that would, for example, allow an originator's approved status to be terminated because of issues arising in its servicing operation. We believe that defects should be addressed in a targeted manner at their source.

Presumably, guarantors would be the parties in the position to cross-default a servicer or originator. In structures where there are several guarantors, engineering and applying cross default would be extremely complicated and operationally difficult.

We do not believe these powers are appropriate for this legislation.

35. Which entities or individuals should have the ability to transfer servicing rights? What threshold should that entity or individual have to meet to request a servicer change? How would the process for requesting a servicer change work?

It is important that servicing rights are readily transferrable because the ability to transfer servicing is supportive of the efficient functioning of the market. It allows existing servicers to manage their operations in the most efficient and safe and sound manner and cope with changes to the broader environment (*e.g.,* Basel III's limitations on MSRs in Tier 1 capital). Servicing transfers also promote competition and new entrants in a market, as they allow smaller servicers and specialty servicers to grow their business. Voluntary transfers should be limited to transfers to eligible, approved servicers and be subject to review by guarantors

and the regulator.[6] Becoming an approved servicer should rely on having adequate capital, investor reporting, operational capabilities and experienced management.

In the current GSE system, servicing rights are generally inexorably bound to all of a seller/servicers' obligations to the enterprises, including those on origination representations and warranties. This limits the attractiveness of purchasing servicing and effectively eliminates the hypothecation of servicing, which is a problem for smaller seller/servicers. We believe these origination and servicing obligations should be separable.

Guarantors should have the ability compel a transfer of servicing under a reasonable and well-understood process. The regulator also should be able to transfer servicing, as a last resort, under a reasonable and well-understood process.

The regulator should also be charged with developing a mechanism for credit risk investors to petition for a servicing transfer.

36. Do you think there should be an electronic registry system to track servicing rights? Should the system include only government guaranteed mortgages?

Yes, there should be such a system; this effectively exists for FNMA and FHLMC loans today. It is appropriate for it to be limited to guaranteed loans.

37. What suggestions do' you have for ensuring that the incentives of servicers and investors that own different tranches are not misaligned?

The appropriate focus of the alignment is among servicers, guarantors, and investors. We believe an appropriately constructed representation and warranty framework goes a long way towards implementing this alignment.

Servicer Compensation

One key issue in the alignment of incentives is the structure of servicer compensation. The regulator of the new government-guaranteed system should be charged with developing servicing compensation standards for the new conforming loan market in consultation with mortgage market participants.

Work is needed on developing the appropriate fee structure and aligning incentives between servicers, borrowers and investors. This is a great opportunity to review the servicer compensation structure. In today's FNMA/FHLMC structure servicers receive a fixed stream of income for all performing loans and receive no servicing income while a loan is delinquent. Delinquent loans cost the most money to service and many in the industry feel compensation today is inadequate for an environment where there are elevated numbers of delinquent loans. However, it is important to have a fee structure that creates incentives for servicers to work to ensure delinquent loans again become current. It is also important to set the fee high enough such that if a replacement servicer is needed there will be adequate compensation to attract a replacement. Setting the fee too low can create a situation where beyond having inadequate compensation to service the loans, there is no incentive for a new servicer to assume the MSR. This is a complicated issue without a simple answer.

Work is also needed to explore if performing and non-performing servicing should more frequently be split into two entities. This is another area where the new regulator could be charged with consultation and standards development to the extent development of such standards is determine to be appropriate.

[6] We note that the CFPB has recently released guidance on servicing transfers.

38. S. 1217 requires servicers to make advance payment to investors when loans become delinquent. What is the impact on each affected participant of that requirement? If that provision is not appropriate, how should advance payments be handled?

It is essential that someone bears the responsibility to advance principal and interest payments (P&I) to the Government Guaranteed MBS. The TBA market will not function if P+I is not advanced to the trust. Servicers also need to advance for taxes, insurance premiums, foreclosure expenses and property preservation expenses. Importantly, these servicing advances are not credit enhancements to the trust and a mechanism needs to be in place to reimburse servicers for such advances.

SIFMA members also believe it is important that the regulator constructs an effective framework to govern the repurchase of delinquent loans out of MBS pools as early as possible, when it is most economically advantageous, based on feedback from market participants including servicers and MBS investors. An effective buyout mechanism would work to materially limit the aggregate amount of advancing required.

We also believe that servicing advance securitizations can become an important funding tool for mortgage servicers in the new conforming market. These transactions are most common now in the private-label securitization market. To facilitate the funding of servicing advances through securitization, a regime including the following features may be advisable. Guarantors would (1) consent to the assignment of the servicing advance asset subject to appropriate conditions, (2) acknowledge a duty to reimburse servicing expenses, (3) agree to waive set-off for claims the guarantor may have against the servicer. This is a high level outline of an approach, for which further discussion is warranted.

Underwriting

40. Should underwriting criteria be established in statute? If so, what underwriting criteria do you support (i.e. minimum down payment, QM definition, QRM definition)? Please provide empirical data on what percentage of the market will be covered or excluded by those criteria and historical loan performance related to particular underwriting standards. If the CFPB'S definition of QM is used in a new housing finance system, how would that impact the likelihood of market participants making non-QM loans? If not, would the government guarantee be vulnerable to legal liability on loans that are reinsured by the government but do not qualify as a QM loan? Should the underwriting standards vary to provide counter-cyclical coverage? Should the loan limits vary by geographic region?

Eligibility criteria in the new system should be based on existing (and more broadly applicable) mortgage lending regulations such as the definition of QM. The ability-to-repay rules represent an active effort by Congress and CFPB to ensure that a borrower's ability to repay is considered, and when a creditor may be viewed as having complied with those standards. It seems like a sensible baseline for this new system and we note that both GSEs have committed to only purchasing loans that meet the QM standards. Any further criteria should be developed by the regulator and not prescribed in statute.

For greatest efficiency and credit availability, all loans eligible for sale into the new conforming market should be deemed to satisfy federal ability to repay requirements and be deemed to be QMs. Presumably, taxpayers would be at risk in the event that a borrower or class of borrowers prevailed in situations where assignees were held liable and would need to make good on the full-faith and credit guarantee to the extent losses exceeded the coverage of the first-loss provider.

In general, underwriting standards should provide a baseline for qualification for a guarantee and therefore should not change significantly on a frequent basis. Frequent changes in underwriting standards could threaten the homogeneity that underlies the TBA market, risking disruptions in liquidity should the changes have a material impact on performance. Similarly, any changes in underwriting standards must also be viewed

in terms of their impact on the attractiveness of the standards to private-sector capital with which the government shares risk. Both of these issues will have an impact on cost and availability of credit**.**

41. ***Should loan level credit enhancements be allowed? Should all credit enhancements be treated uniformly?***

Yes, mortgage insurance and other loan level credit enhancements should be allowed. To the extent that loan-level mortgage insurers and other credit enhancers are capitalized and regulated in a uniform manner by the regulator, their insurance should be treated equally.

Multifamily

43. ***How would S. 1217 affect availability and cost of capital for multifamily housing for various geographies/communities, various market conditions, various income levels, smaller rental properties (1 -4 units; 5 — 50 units), and specialized housing markets (students, seniors, etc.)?***

44. ***Should there be limits on luxury loans? How will this affect production or rehabilitation of existing deeply targeted multifamily housing? Should there be an affordability requirement in order to obtain a government guarantee on multifamily MBS?***

45. ***How should the multifamily guarantee be structured? How many issuers should there be and how would they operate, compared to the G-SEs now? How would small lenders (including CDFIs) access the guarantee?***

46. ***Should issuers have the capability to put loans in portfolio? Should there be any limits on loans in portfolio? If not, will this affect the availability of capital for certain loans now held in portfolio?***

47. ***Who should regulate the multifamily market, and should they regulate the entire market or only guaranteed securities? Should the regulator have waiver authority or other emergency tools for times of crisis?***

48. ***What would you do with existing Fannie and Freddie multifamily businesses? How would you capitalize any new company, including any spin-off of Fannie and Freddie? Would you begin transition immediately, or wait? What will happen to legacy securities? Does multifamily need a role on a board overseeing single-family MBS?***

49. ***Should the multifamily insurance fund be separate from the single-family insurance fund? Should it be explicitly written into the mission?***

Setting up the multifamily programs could remain a distinct process from single-family and may serve as an arena to test new programs or initiatives before they are implemented in the single-family market. This might allow them to move on a faster track than if they were tested in single-family markets alone (but they should not be required to move faster). Once the programs/initiatives have been properly vetted, successful ones can be replicated in single-family markets.

However, if the overarching goal is affordable housing (as distinct from affordable homeownership) there may be benefit from having single-family and multifamily activities ultimately housed in the same entities.

Private Label Securities

<u>General Comment on this section</u>: As we have noted above, we believe the focus of the reform of the conforming mortgage market should remain narrow and closely related to what is needed for the operation of the new conforming market. While some of the questions below address important topics, we do not believe they should be dealt with in this legislative process (and in some instances, should not be dealt with in any legislative process).

50. ***How can standardization in MBS documentation be achieved? What incentives can be offered to incentivize PLS issuers to standardize?***

While greater standardization is an important goal of many PLS market participants, we do not believe contractual standardization can or should be legislated. Market participants have worked over a number of years to discuss what standards are appropriate as they tried to restore activity in PLS markets.In the last year or so we have seen an uptick in PLS activity, and we believe this will promote further market discussion and over time lead to a new regime that is broadly accepted in the market. Issuers and investors may find benefits in non-standard products and market experience will determine the appropriate balance between standardization and differentiation. New products may also require non-standard documentation.

We would emphasize that no amount of standardization would permit the private label market to obtain the same level of homogeneity/liquidity as currently exists in the guarantee-supported TBA market.

51. ***Which is more feasible: a trustee fiduciary standard or requiring a PLS trust to have a credit risk manager (and who might serve in that role)?***

The SEC is expected to include requirements for a credit risk manager in private-label mortgage securitization transactions when it finalizes Regulation AB2. SIFMA supported the concept that underlies the SEC's proposal, and suggested some revisions to the proposed SEC regime. Many newer RMBS transactions utilize a form of this structure.

52. ***Should servicing agreements provide more detail and specify in detail how to manage troubled mortgages?***

We do not believe this is an issue to be addressed in statute.

53. ***Is there a need to examine the current treatment of creditor and assignee liability and its impact on investment?***

This legislation should in no way weaken protections from, or expand the application of, assignee liability. There is a demonstrable, direct one-to-one relationship between assignee liability in the secondary residential mortgage market and the willingness of investors to purchase residential mortgage loans and mortgage-backed securities. In this regard, analogies to financing the purchase of personal property or commercial real estate are inapplicable.

Virtually all agree that a robust private securitization market is required to provide credit to eligible borrowers at affordable rates on a long term basis. This goal will be severely compromised if investors perceive that mortgage-backed securities are backed by mortgages with impaired or limited enforceability, particularly if "defects" that affect enforceability cannot be reasonably "diligenced" in advance by the purchasers.

We have actual experience on this point that is instructive. In 1994, Congress enacted the Home Ownership and Equity Protection Act ("HOEPA") by amending the Truth in Lending Act. HOEPA is principally implemented by Section 32 of Regulation Z. HOEPA imposed additional substantive responsibilities on

creditors of non-purchase money residential mortgage loans that exceeded certain financial triggers based on the loan's interest rate or total points and fees. That is why Section 32 loans are referred to as "high cost" loans. The theory was that higher priced loans usually involved borrowers who were less capable of protecting themselves.

Since 1994, virtually no one knowingly makes, buys, services, or securitizes "high cost" loans. The reason is simple. It is not the substantive requirements for such loans, which now are the norm rather than the exception, rather, it is the federal repeal of the "Holder in Due Course" rule with respect to such loans that has caused such loans to become toxic in the marketplace. The Dodd Frank Act recently expanded the number of home loans that are potentially subject to HOEPA by reducing the financial triggers, expanding the types of expenses that fall within the definition of "total points and fees," and adding purchase money loans to the mix.

An assignee of a HOEPA loan is subject to all claims and defenses with respect to the mortgage that the consumer could assert against the original creditor, unless the assignee can demonstrate, by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence could not determine, based on the documentation, that the loan was a HOEPA loan. This assignee liability provision is not limited to claims and defenses arising solely as a result of violations of HOEPA, but rather applies to any type of legal claim (*e.g.,* a claim arising out of a state law violation) that a consumer may assert against the originating lender, irrespective of whether the claim arises under HOEPA. A number of states have passed anti-predatory lending laws that provide assignee liability similar to that found in HOEPA with similar lack of market acceptance.

We have every reason to believe that the market will react in the same way if similar liability is expanded. Defensive claims unrelated to the servicing of the loan can eviscerate the outstanding principal balance of a loan and essentially cause the loan to evaporate into thin air. Investors have little appetite for asset-backed loans that are not backed by enforceable assets.

We see this same debate presently being played out with respect to the CFPB's new "qualified mortgage" rules pertaining to the "ability to repay" requirements adopted under the Dodd Frank Act. Violations of these requirements exposes innocent loan holders to defenses to foreclosure with the possibility of significant actual, statutory and enhanced damages being offset against the outstanding debt to be enforced. We note that the Federal Housing Finance Agency announced in May of this year that loans subject to this defense to foreclosure because they are not "qualified mortgages" will not be eligible for purchase by the GSEs.

While ordinarily a rational investor may price the heightened legal risk rather the withdraw from or reduce its participation in the capital markets, this seemingly less drastic alternative poses its own set of material legal problems for investors. First, pricing this risk could cause the loan to exceed the 3 point maximum to qualify for "qualified mortgage" status under federal law. Second, pricing a loan for lesser liquidity and higher legal risk could cause the loan to become a "high cost" loan under HOEPA, particularly under the recently adopted lower financial triggers. This is another example of how the Draft will not operate in isolation but is inextricably tied to federal law as well.

The debate goes well beyond the policy question over whom should bear the risk of a third party's origination violations as between a consumer and an innocent subsequent holder. It really boils down to whether investors will agree to bear the risk of loss on loans that are priced for the availability of enforceable collateral but where such collateral may prove to be illusory in foreclosure. And unlike the debate over whether a buyer of a defective appliance or car should be required to pay for something that simply does not work, as is the case with the FTC's Holder Rule, in this case neither the offending loan nor the house secured by the loan is necessarily itself defective and the consumer obtained, spent and received the benefit of the proceeds of the loan. Moreover, and equally importantly, there is no direct or necessary nexus between the limitation on the remedy of foreclosure and the violation that is being asserted against the holder.

Single Securitization Platform

54. ***Should the platform just be used for government guaranteed securities, or should it also be used for non-guaranteed securities?***

The platform should be designed to allow for use by private-label securitization but we would strongly oppose any such mandate. The platform could become an important vehicle to the issuance of more homogenized, commodity-like RMBS, but it cannot be forced to become that.

This platform will be successful only if there is a large private investment base for the MBS issued through it. One of the most important sources of private capital for MBS in recent years are mortgage REITs, which, as the government sponsored entities withdraw from the market, play a critical role in private capital formation for the residential housing market. Accordingly, all MBS issued through the platform, including risk sharing transactions and guaranteed securities, should be designated by Congress to be "mortgages and other liens on and interests in real estate" for purposes of the exemption provided by Section 3(c)(5)(C) of the Investment Company Act of 1940, as amended. This designation is crucial if mortgage REITs are to continue to bring new private capital and demand for MBS issued through the platform.

55. ***Should the platform be owned by the government or private market participants? If private, should it be non-profit? Which platform ownership model provides a framework that best attracts qualified market experts to operate the platform, encourages thoughtful risk management, promotes open access and minimizes potential conflicts of interest?***

We are developing our thinking on this topic. The answer is contingent upon the broader structure of this reform effort:

- If it is not a risk-taking entity (a limited-purpose securitization entity), the platform could be a private industry consortium or owned by the government. If it is a private entity, it should still be required to expose material changes to its rules to public notice and comment (in a similar manner to how DTC and other entities are currently required to do so under the SRO regulatory structure of the SEC). We note that Dodd-Frank sets out standards for the regulation of financial market utilities.
- If the platform is a risk taking entity (*i.e.,* guarantor, aggregator, etc), it should be a government entity. The government will need to capitalize the platform as it will enter in to the chain of liability (*i.e.,* guaranty obligations, representations and warranties, etc) even if it attempts to sell all "actuarial" credit risk to capital markets investors.

Transition

58. ***How long should the transition from the current system to a new system take?***

59. ***What kind of benchmarks, metrics and deadlines should be set to ensure meaningful progress to a new system and prevent market disruptions? In what sequence should events occur in the transition? Should a new housing finance system with new forms of M.BS (that may include first loss private capital) and a common securitization platform be fully operational before Fannie Mae and Freddie Mac's ability to guarantee MBS is shut down?***

61. ***What kind of flexibility or emergency powers should be included in any legislation to address any market disruption that may occur during the transition?***

The transition will involve changes to the legal and operational framework at the core of mortgage finance. It begins immediately with the implementation of the legislation and continues with the development of guarantor and other participant capital and operational standards. The transition should be as rapid as

possible but must be long enough to properly build and test the operational components (*e.g.* the common securitization platform and other components of the new system). In any case, it must extend to the point where the new system is fully operational and capable of standing on its own. The GSEs should be able to continue their business operations until the new system is fully operational – this is the most effective safety valve in the transition.

The regulator should have at least one year from the date of passage of the act to design, receive comments and publish plans for the:

- Common Securitization Platform
- Standard selling, servicing and securitization processes, policies and legal documentation
- Form of any new security, with transition plans.

The regulator should be able to set capital standards and prompt corrective action standards similar to the powers of regulators in the banking system. This would include reducing or eliminating the private capital first-loss requirement in cases of significant market disruption.

60. Should/can existing GSE MBS be re-securitized as FMIC securities? Would 10 percent of first loss risk be sold off? Should holders of agency MBS be forced to re-securitize?

We know the required end state at this point. The outcome must be that new securities are fungible with the existing securities in a single TBA market that is as large as possible. Resecuritization (functioning as an exchange program to convert legacy MBS to the new form) may or may not be needed. If market participants believe that it is needed, legacy GSE MBS investors should be able, but not required to, exchange their bonds for the new security.

If there is a conversion program, legacy bonds should not require private capital credit enhancement. Doing so would be immensely expensive for all holders of existing securities, including the government through the conservatorships of the Enterprises. Investors should be able to exchange legacy GSE MBS for the new bonds indefinitely and without cost. Some type of 'clean up' call may be appropriate if/when the existing stock of legacy securities becomes very small such that the costs of maintaining the exchange program exceed its benefits. These would be decisions made by the regulator.

62. How should Fannie Mae and Freddie Mac be wound down, and how should outstanding claims (especially to taxpayers, first and foremost) be addressed? How should employee retention and outstanding litigation issues be handled? Should a regulator have broad contracting authority to aid in the wind down and transition?

The GSEs should be wound down with a reasonable period after the new system is fully operational. The personnel and systems necessary to support their legacy securities should be transferred to the platform; valuable personnel who manage the Enterprises' credit risk could transition to private sector entities; and other employees may be transferred to the government to as necessary to deal with any receivership issues and sales of businesses in a way that maximizes taxpayer value (*e.g.,* employees of the multifamily business of the existing GSEs). Market compensation should be paid to those employees transferred.

Responsibility for existing and new litigation should be transferred to the regulator as receiver.

Existing debentures, receivables, derivatives and other corporate obligations must be transferred to or otherwise be paid by Treasury until maturity.

63. What should happen to the automated underwriting systems, the new common securitization platform, and other existing systems after Fannie Mae and Freddie Mac are no longer writing new business? Would the existence or elimination of these systems going forward create or reduce barriers to entry for new market participants? If sold off how will existing systems be priced?

The common securitization platform can and should be central to the new conforming market as it will be the engine that facilitates the large and liquid market for a single MBS.

DU and LP are some of the most valuable infrastructure of the existing GSEs. To the extent that the GSEs are disposed of, systems such as DU and LP should made available for use by other participants. Discarding these systems would be a waste of valuable assets. If components of the existing GSEs are reorganized into private sector entities, they would have a significant competitive advantage over other firms if they remained in sole possession of DU and LP. Any new guarantor should also have access to the source code.

64. Should certain business lines of Fannie Mae and Freddie Mac be spun out or sold to private entities? If so, what capital needs would be required of the business lines in order to maximize the value of the entities and thus the return to the taxpayers?

The regulator should have discretion to accelerate disposition of either SF or MF segments separately so as to maximize market value and stability. The MF businesses should be spun off or sold with access to a FMIC-like guarantee, also with additional competition. This is likely to be possible more quickly than the resolution of the single-family businesses given that the multi-family businesses are less central to those markets, in comparison with the outsized role of the single family businesses.

There is much value in the single-family businesses of the GSEs and we believe they should ultimately be returned to private ownership. Given their size, however, this will require a long period of capital formation -- they cannot be quickly "spun out".

As noted above, DU and LP source code should become open source.