Invested in America

August 23, 2013

The Honorable Tim Johnson
Chairman
Senate Committee on Banking, Housing, and Urban Affairs
Washington, D.C. 20510

The Honorable Mike Crapo
Ranking Member
Senate Committee on Banking, Housing, and Urban Affairs
Washington, D.C. 20510

Dear Chairman Johnson and Ranking Member Crapo,

On behalf of our member firms, SIFMA[1] is pleased to provide the following summary of our views regarding the Committee's consideration of legislation to reform nation's housing finance system. SIFMA looks forward to working collaboratively with the Congress in analyzing and commenting on how policy choices made will affect the ability of secondary mortgage markets to provide liquidity to lenders, and thus the availability and cost of credit to support housing finance.

Priorities for the Future System

- **Preserve the Ability of Secondary Markets to Support the 30-year, Fixed-Rate Mortgage:** The 30-year fixed rate mortgage is a stable and predictable way by which most Americans have historically financed their home purchases. While adjustable rate and shorter-term mortgages have benefits of their own, the 30-year mortgage provides for an affordable and predictable payment for those borrowers for whom other products are not necessarily appropriate. Such 30-year mortgages, however, present significant risks to lenders and investors, in that the stream of interest income is locked in over a long period, regardless of where funding costs move. To manage this risk, lenders need access to a liquid, forward market for mortgage loans. Without such a market to manage interest rate risk, lenders would be less willing to originate 30-year fixed rate loans, and many would likely not originate them at all.

- **Preserve the TBA Market so that affordable mortgages will be available**: SIFMA's primary focus in considering reform of the housing Government Sponsored Enterprises ("GSEs") is the preservation of a liquid, forward market for the trading of mortgage-backed securities ("MBS"). Today, the "to-be-announced" ("TBA") markets serve this function. The TBA market serves a critical function in our current system, allowing mortgage originators to sell conforming loans before they are originated, enabling them to provide interest rate locks to borrowers well in advance of closing while hedging their risk, and facilitate the most efficient mortgage origination process. This allows the borrower/home buyer the ability to lock in a rate well in advance of settlement. Furthermore, the TBA market provides the necessary liquidity that enables a national market, whereby regional differences do not impact credit availability for borrowers in particular locations, as MBS traded in the TBA market tend to be

[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.

geographically diverse. In addition to the loan origination aspect, the TBA market provides an important benefit to investors such as pension plans, 401(k) plans, mutual funds, state and local governments, and global investors. The homogeneity established by way of the TBA market aids in the attraction of global capital for U.S. mortgage lending. Indeed, with over $250 billion of securities traded on an average day, the TBA market is the largest and most liquid secondary market for mortgages, and second only to the U.S. Treasury securities market in terms of bond market activity.

- **A Government Guarantee is a Key Component of the Homogeneity Required to Support a Vibrant TBA Market:** Homogeneity is what makes the TBA market succeed. In this market, buyers and sellers agree on certain terms of a trade, but importantly buyers do not know all of the specific characteristics of the security they have purchased until two days before the trade settles. This is what allows liquid forward trading, and allows originators to hedge production pipelines. The homogeneity is driven by two main factors: standardization of terms, and the absence of credit risk. Terms are currently standardized through the GSE's lending, servicing, documentation and other guidelines. Credit risk is addressed though the implied but near-explicit government guarantee on the principal and interest payments of the MBS. A structure whereby private capital would take a first position loss with a limited government guarantee supporting losses beyond the first position loss would serve to diminish any credit risk concerns. This allows for what is essentially a one-factor analysis of the market – that of prepayment/interest rate risk, or the risk that borrowers will refinance or otherwise repay principal before it is due in response to changes in interest rates. It is a so-called "rates market", as opposed to a "credit market". The guarantee serves another beneficial function by attracting investors who would otherwise not invest in MBS. Many foreign investors including governments, and certain domestic investors, are unable or unwilling to invest in mortgage credit risk. They will only invest in interest rate/prepayment risk – they are "rates investors". Possibly the most important benefit of the guarantee is the support that it provides in the market in times of crisis – it allows investors to fund mortgage credit creation even at times when other markets become less liquid. This occurred in 2008, when private-label MBS markets completely shut down, bank portfolios significantly contracted lending standards, and the GSE and FHA markets took on the vast majority of credit provision. Without the guarantee, credit would have dried up as it did for corporations and other significant borrowers. And what mortgages could be sold would have been far, far more expensive. No one disagrees that the role of the government must shrink, but it must also be recognized the critical counter-cyclical role the guarantee plays.

- **Significant Amounts of Private Capital Should Stand in Front of the Taxpayer:** The risk that taxpayers are exposed to losses should be very remote and that risk should stand behind a number of levels of private capital acting as a shield or buffer. In arranging such a system, the various sources of private capital protecting the government should be recognized:

    - Borrower equity;
    - Equity capital in loan- or pool-level mortgage/bond insurance providers and/or providers of corporate guarantees.,[2] and;
    - Well-capitalized insurance reserve funded by fees paid for government backstop.

- **Well-capitalized Intermediaries Should Stand Between Originators and MBS Investors:** The market for guaranteed MBS will need an entity that stands between originators and investors in MBS. Such an entity or entities would serve the role of aggregators and provide a cash window for smaller banks to ensure access to the securitization markets. It is not clear that large banks will have an incentive to serve this function for the entire market, nor is it clear this is a desired outcome, as it would tend to concentrate market share in a few entities.

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[2] We note that such entities should be required to be adequately capitalized and regulated to withstand events such as the recent market downturn and avoid the recent experience of rescissions and denied claims.

- **The TBA Market Requires Uniformity of Terms**: Simply creating a single securitization platform to be used by a multitude of issuers will likely not be as effective as the current Ginnie Mae model. This is principally due to the controlled environment in the Ginnie Mae/FHA model. The success of a FMIC-like model will require greater centralized control. GSE reform legislation should require that securities carrying a full government guarantee and issued to be traded in the TBA market be identical in terms of form (e.g., structure, payment dates), and underlying contractual provisions (e.g., offering documentation, pooling, servicing, disclosure, etc), regardless of who issues them. To the extent non-guaranteed securities are issued, or securities are issued without regard for TBA eligibility, issuers should be able to choose the form that is most appropriate for their transaction.

- **Expectations for Private Capital Should be Realistic about its Capacity:** Currently, more than 80% of loans are securitized and if this is held constant as the government's role is reduced, capital markets would need to begin supporting hundreds of billions of dollars of lending. SIFMA and its member firms do not believe it is realistic to assume a rapid increase of investor appetite for private mortgage credit risk and further note that in the six years since the onset of the financial crisis, prime mortgage backed securities issuance has been but a small fraction of this demanded number. There is no evidence that sufficient, capital is anywhere close to today's rates or terms. Importantly in the most active years in which the housing bubble was formed, prime MBS issuance was less than $300 billion dollars. Most of this was AAA-rated, senior in the capital structure, and not considered particularly risky. In contrast, today's discussions of credit risk sharing imply private capital taking on significant amounts of first loss risk - that is, the most junior part of the capital structure. At the peak of the bubble, only a fraction of that $300 billion of prime private label MBS represented subordinate portions of the capital structure and/or first-loss types of risk.

    - **In the context of current GSE reform debate, this argues for a flexible approach to risk sharing;** an approach where required levels of risk sharing fluctuate with demand for mortgage credit. If constructed otherwise, the regime will tend to be pro-cyclical and exacerbate booms and busts. Any risk sharing requirement should not mandate capital-markets based risk sharing be executed concurrently. Ideally, a well-capitalized intermediary will be an entity that can warehouse mortgage risk for a period of time and lay it off into private markets (CDS, CLNs, securities, etc) as market conditions allow. Furthermore, in the context of risk sharing, investors will prefer facing a well-capitalized, stable entity as opposed to a multitude of small and inconsistently capitalized issuers when it comes to counterparty or representation and warranty risk.

    - **Required amounts of risk sharing should be calibrated to recent market dislocations and loss experiences.** For example, this could be a level that reflects the credit losses sustained by the GSEs in the recent crisis and is adjusted for the credit parameters for mortgage product receiving a government guarantee. We expect that looking back to "Great Depression" levels of loss will result in both scarce and expensive mortgage credit.

- **Reform or Avoid Policies that Repel Private Capital or Generate Uncertainty:** Private market participants demand transparency and certainty in their investments and capital allocations. Many factors and events during and after the recent financial crisis have caused private capital to retreat from funding mortgage credit. For mortgage investors, security performance and government policy upended expectations held before the downturn. For lenders, retroactive changes to GSE and FHA policies have caused a contraction in the provision of credit, even if it technically qualifies for a given program.

  In particular, the potential for seizures of loans through a municipality's use of eminent domain run the risk of causing private capital to once again flee the mortgage markets. Such actions, if they are allowed by policymakers and/or the judicial system to proceed, would damage investor confidence in mortgage markets and drive the cost of mortgage credit higher, and availability therefore lower. Policymakers must recognize the national importance of this and ensure that individual municipalities or other governmental entities are not able to cause damage and act in opposition to the national interest. Above all, federal government programs and entities such as FHA should not be party to such activities.

Priorities for the Transition

- **A Timeline for Transition Should be Long Enough to Facilitate Continual Liquidity and Flexible to Accommodate Unforeseen Challenges:** SIFMA members believe that any legislation to reform the existing system should contain: (1) a long, flexible transition period that does not *mandate* the dissolution of the current system for at least 10-years,[3] (2) a careful monitoring of market conditions (3) adaptability to unexpected reactions and consequences and (4) consideration of pending regulatory changes related to mortgage lending and securitization, specifically relief from portions of the Dodd-Frank Act to facilitate the return of private capital to the housing finance system .

- **Expectations of current bondholders must be supported through clarification of guarantee for existing securities:** Not making explicit the implicit guarantee on existing MBS and corporate debt will disrupt the markets for these securities, harm the confidence of investors who are needed to participate in the new market, and make impossible a seamless continuation of the liquidity from the current markets to the future markets.

- **A bridge should be built to maintain liquidity throughout the transition period, through an exchange process or mechanism:** Related to the point above, policymakers should consider how a maximum amount of the liquidity from the current markets can be brought forward into the new market. This could involve an exchange program for holders of existing MBS to swap into the new form of MBS if the new MBS is materially different. In any case, the regulator of the future market should have the flexibility to design an appropriate transition mechanism.

Per the request of your staff, SIFMA will soon be submitting a detailed analysis of S. 1217 (Corker-Warner) as an accompaniment to this letter. Beyond these submissions, SIFMA and its member firms stand ready to assist you and your colleagues as you proceed with this critically important reform effort that should lead to the establishment of a more sustainable housing finance system.

With kindest personal regards,

Kenneth E. Bentsen, Jr.
President

[3] This *does not* imply that the transition *must* take 10 years, but rather means that the shift to a more sustainable housing finance system should be designed so that market acceptance will broadly dictate the speed of the transition.