



**Written Statement of:**

**Thomas Hamilton  
Managing Director  
Barclays Capital**

**On Behalf of:**

**The Securities Industry and Financial Markets Association**

**Before the United States Senate Committee on Banking, Housing, and Urban Affairs  
Subcommittee on Securities, Insurance, and Investment**

**“Examining the Housing Finance System: The To-Be-Announced Market”**

**August 3, 2011**



Good morning Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee. I am Thomas Hamilton, Managing Director, at Barclays Capital, where I am responsible for securitized products. I am pleased to testify today on behalf of the Securities Industry and Financial Markets Association (“SIFMA”)<sup>1</sup>.

We appreciate the opportunity to discuss the most liquid secondary markets for mortgage loans and mortgage-backed securities (MBS) in the world – the “To-Be-Announced” (TBA) markets. These are critically important markets which help consumers purchase homes, and we would like to discuss in detail how they work, the benefits they confer on consumers and the economy, and their important role in mortgage finance.

### **Summary**

Housing is a critical component of our economy, and is the center of a virtuous circle: housing begets jobs, which beget housing. Consequently, the U.S. mortgage market is enormous; for example the home mortgage market is approximately equal in size to the total size of U.S. bank balance sheets. Given that banks engage in activities other than residential mortgage lending, their balance sheets alone cannot meet the country’s need for mortgage credit. Ginnie Mae, Fannie Mae, Freddie Mac (together, “the Agencies”) and private institutions use the process of securitization to provide capital that allows for the growth of mortgage lending beyond the capacity of bank balance sheets. Today, private securitization and the Agencies finance nearly 70% of outstanding home mortgages and it is therefore imperative that securitization continue to play a key role in any future mortgage finance system. The market for MBS issued by the Agencies is approximately three times the size of the outstanding non-agency MBS market. In this Agency MBS market, the TBA market is the single largest component. The TBA market is currently the key to funding mortgage lending, and because of this it plays a critical role in housing and the U.S. economy.

The enduring liquidity of the TBA market, in contrast to the lack of issuance in the private MBS markets, preserved the availability of mortgage credit in the recent crisis. This ability to maintain liquidity during stress periods is a key benefit of the TBA markets. Furthermore, the liquidity and resilience of the TBA market attracts a wide range of investors who provide vast capital that is cycled into mortgage lending, including retirement savings vehicles, insurance companies, and foreign investors.

The vast liquidity and forward-trading nature of the TBA market provides key benefits to consumers, such as the broad availability of 30-year fixed rate mortgages that may be prepaid without penalty, and significant and consistent liquidity in the secondary mortgage market. This results in a stable and attractive funding source for lenders that allows them to provide lower mortgage rates and longer-term "rate locks" for borrowers, and efficiently recycles funds back to local lenders to enable another round of mortgage lending.

Of course, the TBA market is facilitated by the guarantees of the Agencies, and therefore the support of the government that stands behind them. Currently over 90% of mortgages are financed through a program of

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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).



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one of these three Agencies. This level of support is possible because Agency MBS do not expose investors to credit risk, and therefore the market is attractive to risk-averse investors that have vast sums of capital available for investment. Without the TBA market, we believe that the majority of this investment capital would be directed elsewhere, reducing the amount of funding for and raising the cost of mortgage lending. Therefore, SIFMA believes strongly that maintaining a liquid and viable TBA market should be considered as Congress addresses housing finance reform.

With that said, the reality is that that this current outsized role of the government is not sustainable over the long term, and should be reduced. The TBA market's role, and the government's role, should shrink as the private markets regenerate over time. The means of achieving this rebalancing are very complicated and consequential on a national, financial, and personal level. While SIFMA believes the TBA market should play a role in the future, it should certainly not be 90% of the market. There are a number of challenges to the resurrection of non-agency securitization, including the significant uncertainty faced by non-agency MBS investors and issuers. The rules of the road, for both sides, are not clear. Until they are, it will be challenging for issuers and investors to see eye to eye on securitization transactions, at least in the volume and frequency that is necessary to fund mortgage credit demand. Being able to withdraw the government from mortgage markets will require a carefully planned and sequenced transition which should take a number of years. It is essential to remember that the necessary volume of non-agency investors will not simply appear because we want them to. They must be drawn back into, and made comfortable with, private label securitization and its regulatory environment.

We believe that it is critical that the planning and execution of significant changes to the funding of mortgage loans be done with attention to detail, be based on sound analysis of costs and benefits, be mindful of unintended consequences, and create a long-term beneficial and stable environment. While we cannot predict the future, we can use the past as a guide and apply lessons learned and mistakes made, the good and the bad, to a design that will stand the test of time.

We hope that the testimony we present today will be helpful in educating policymakers about how mortgage loans are funded in the capital markets, the critical role of the TBA market, and some of the critical issues that must be considered to move forward.

Thank you for this opportunity and I am happy to take any questions.

## Discussion

### A. Terminology

We will first quickly review basic terminology to set the stage for the rest of our testimony.

- **Mortgage-Backed Security (MBS)** – An MBS is a type of bond collateralized by mortgage loans that represents an undivided fractional interest in that pool of loans. Beneficial ownership of this interest may be transferred in trading markets. Payments to bondholders result from the underlying payments and cash flows on the mortgage loans that serve as collateral. Cash flows to MBS investors are variable, as most mortgage loans are prepayable without penalty.
- **Agency MBS** - Agency MBS are collateralized by loans meeting Fannie Mae (FNMA), Freddie Mac (FHLMC), or Federal Housing Administration (FHA) underwriting guidelines, and are issued and/or guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae (GNMA). Agency MBS are perceived to have little to no credit risk because they carry either an explicit government guarantee (GNMA) or an implicit guarantee (FNMA and FHLMC). Unlike Fannie Mae and Freddie Mac, Ginnie Mae does not issue debt or mortgage-backed securities. It is a guarantor of privately issued securities collateralized by loans insured by the FHA, Veterans Administration, and the Rural Housing Service.
- **Non-Agency MBS** – So-called non-agency MBS are collateralized by a wider variety of loan types than Agency MBS, and are issued by private lenders, and are not guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae. Non-agency MBS are generally structured into tranches with varying degrees of repayment priority, and therefore introduce varying degrees of credit risk to investors. Credit risk is the risk of losses if borrowers do not repay their loans. Recently, there have been two notable non-agency MBS transactions been backed by extremely high quality, high-balance loans (a.k.a. “Jumbo Prime” loans); prior to 2008, non-agency MBS also included “subprime” and “Alt-A” loans.
- **Common MBS Structures**
  - 1 *Pass Through* – A pass through security is the simplest form of MBS. Payments on the loans are delivered to investors as they are paid by borrowers (i.e., they are “passed through”). Most Agency MBS are issued in pass through form. MBS eligible for TBA trading are in the form of pass-throughs.
  - 2 *Collateralized Mortgage Obligations (CMO) and Residential Mortgage-Backed Securities (RMBS)* - CMOs and RMBS structure cash flows to investors by dividing borrower payments in to various “tranches”, or slices that are entitled to particular streams of payments. Agency securitizations are generally called CMOs, and Non-Agency securitizations are usually called RMBS.
  - 3 *Real Estate Mortgage Investment Conduits (REMIC)* - In 1986 amendments to the tax code created favorable treatment for mortgage securitization structures that met certain requirements. These rules are administered by the Internal Revenue Service. Most MBS are issued in compliance with REMIC regulations.



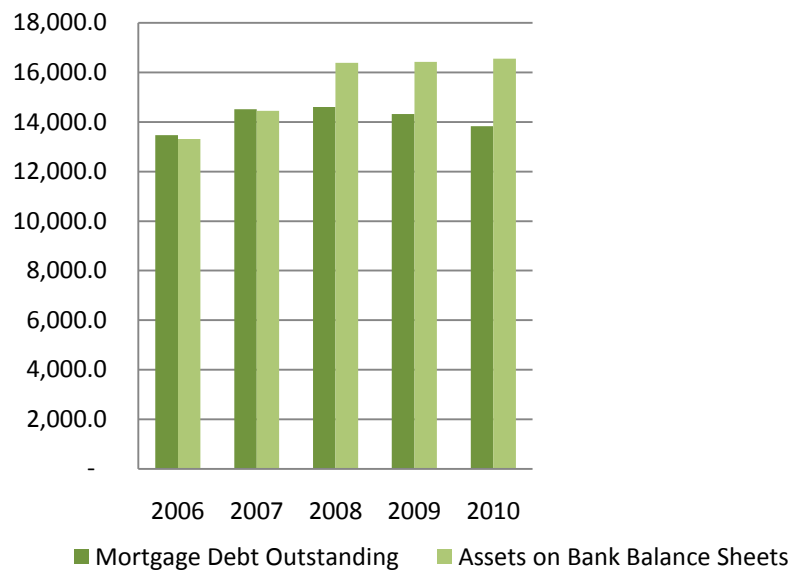
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- **To-Be-Announced (TBA) Trading of MBS** – To-Be-Announced trading is a trading convention whereby homogeneous MBS are traded for forward settlement and the purchasing party does not know the specific identity of the MBS pool to be delivered. Trades are executed based on a limited number of criteria, including issuer, coupon, term of mortgage collateral, and settlement date.

## B. Overview of the U.S. Mortgage Market, and the Importance of Securitization

Chart 1 below shows the enormous size of the U.S. mortgage market relative to bank balance sheets. The size of the mortgage market has previously exceeded, and is currently nearly equal to the total size of bank balance sheets. This chart demonstrates that there is not enough capacity in the U.S. bank balance sheets to fund our nation’s housing stock alone. Through securitization we are able to recycle capital available for lending and attract vast sums of new capital to the markets.

**Mortgage Market and Bank Balance Sheets Comparison  
(\$ Trillion)**



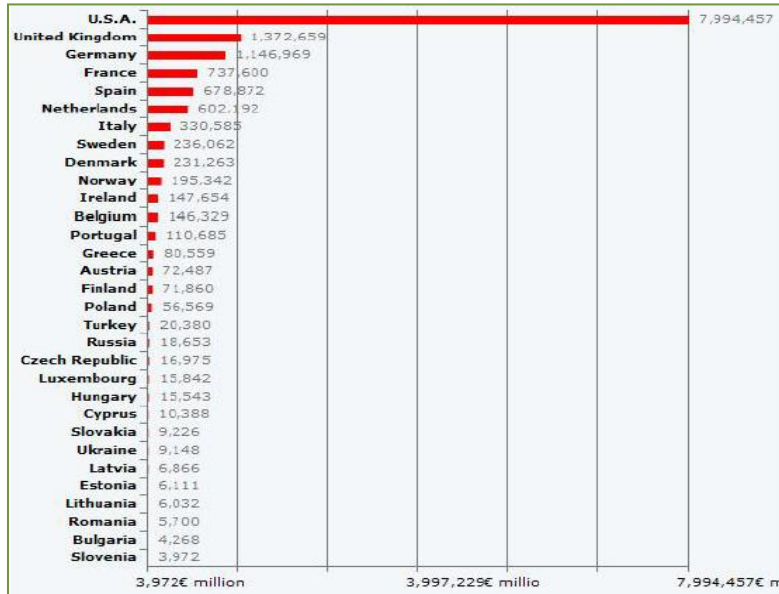
*Source: SIFMA analysis of Federal Reserve Data*

To put this in a global context, the U.S. mortgage market is larger than the combined mortgage markets of all of the countries in Europe. For this reason, the U.S. mortgage market is not directly comparable to any single other market in the world.



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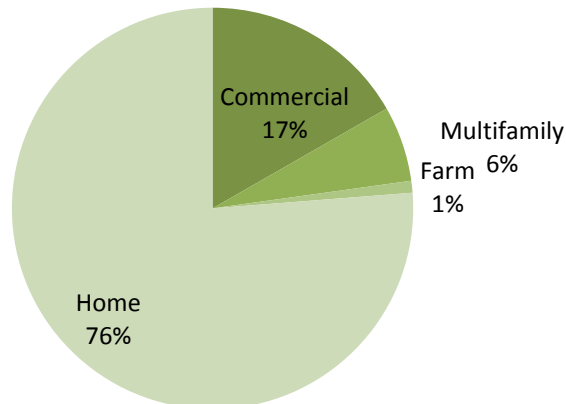
### Outstanding Mortgage Debt (In Euros, 2009)



Source: Hypo.org

Three quarters of U.S. mortgage debt is residential mortgage debt, as shown below.

### Composition of Mortgages in the United States 2010



Source: Federal Reserve

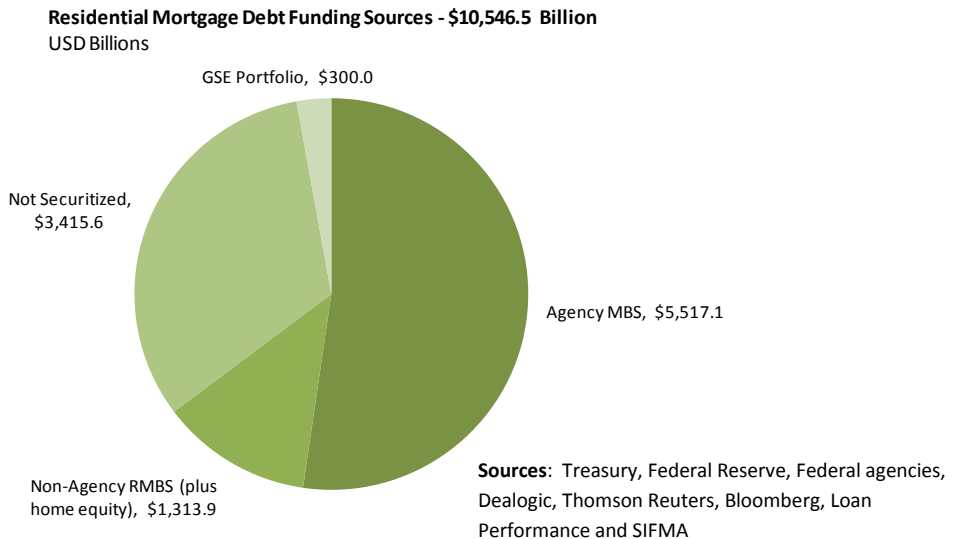
Securitization and the MBS markets play a critical role in funding this residential mortgage lending. We have shown above that the mortgage market is enormous, that it is primarily a residential market, and that



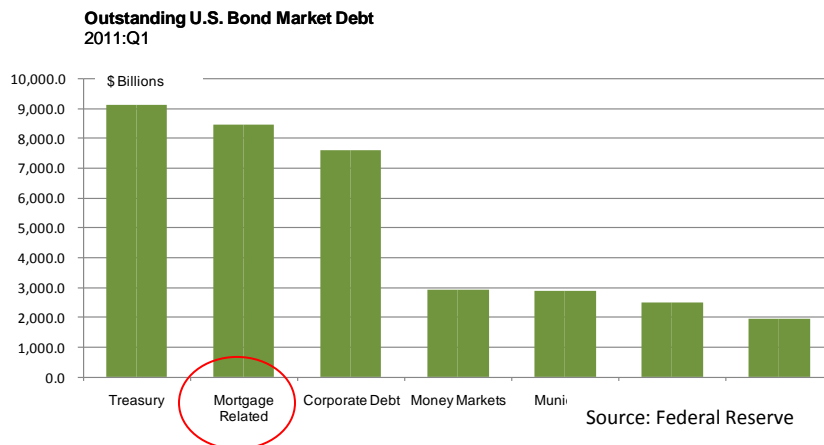
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securitization is necessary to fund this level of credit creation. We will now turn more specifically to the role of securitization and secondary markets in funding these markets, and discuss who ultimately provides this capital.

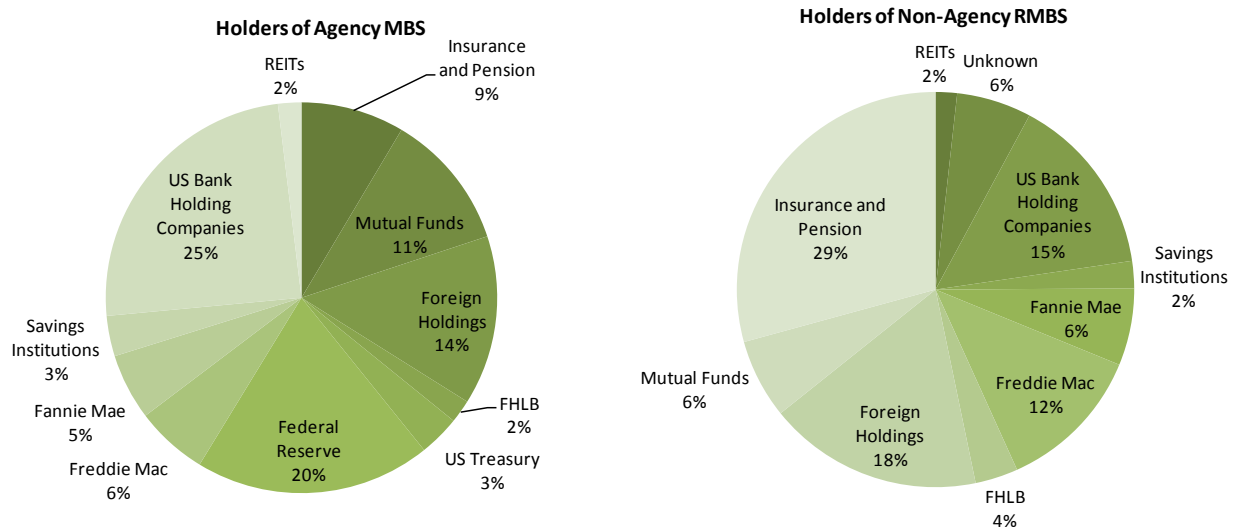
Below is a chart that outlines how mortgages are funded in the United States. 67%, or \$7.1 trillion, of home mortgages are held in a GSE portfolio or securitized (agency and non-agency). Secondary markets, therefore, are responsible for funding two thirds of residential mortgage lending. The securitized home mortgage market can be split between agency MBS and non-agency MBS, with 81% of all MBS in the form of an agency pass-through or agency CMO.



To put the size of the MBS markets in perspective, the chart below places them in the context of the other fixed-income markets. They are larger than all markets but for Treasuries.



Another important issue to understand is who holds these securities. Banks, pension funds, mutual funds, and insurance companies are key investors in MBS. Foreign sources of capital, including investment companies, sovereign wealth funds, and other government entities are also critical sources of capital for U.S. mortgage markets. Below are two charts which outline the holders of both agency MBS and non-agency MBS.



Sources: Federal Reserve, Treasury, WSJ, SIFMA

The most critical point of this testimony to this point is this: in any consideration of the future of housing markets, the future of the GSEs, or the future of mortgage lending, it is critical to remember that these markets will not work without the participation of investors. The U.S. mortgage market, as shown above, is huge. It is a key component of the economy and job creation, and is largely funded by many different kinds of investors. Therefore, any housing reform or changes to the current regime must be viewed through the lens of investor needs, and what investors are willing to pay for a given investment opportunity.

## C. The Role of the Agencies

### A. What they Do

The Agencies have long played a crucial role in the U.S. mortgage finance market. Fannie Mae and Freddie Mac purchase loans, securitize them, and guarantee the timely receipt of principal and interest on their MBS. Ginnie Mae securitizes government-insured FHA, USDA, and other government guaranteed loans, and places a similar guarantee of timely payment of principal and interest on the mortgage-backed securities. For the last 30 years, the Agencies have played a critical role in mortgage finance, utilizing securitization to expand the supply of capital available for mortgage lending.

Standardization has been a key benefit of the Agency model. Due to their size and the scale of their operations, the Agencies have driven standardization of mortgage loan documentation, underwriting, servicing,





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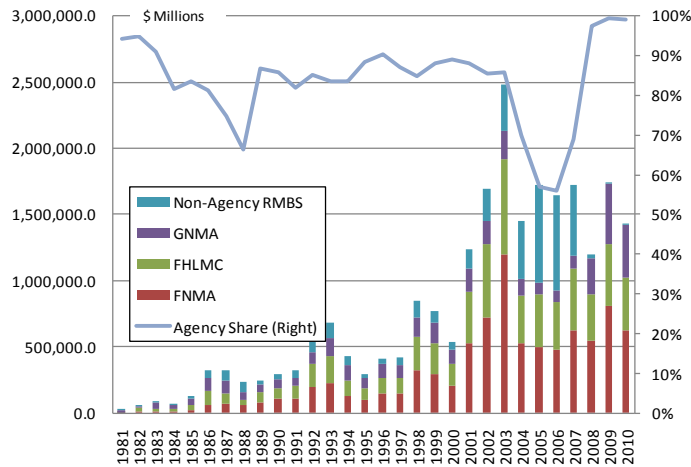
and other items in ways that have created a more efficient origination process. This standardization extends beyond the Agency market, and has driven standardization of lending processes more generally, across product types, markets, and across institutions.

Perhaps more importantly, the activities of the Agencies 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. Banks were able to access a longer-term funding source to match the terms of the mortgages, transfer risk, reduce balance sheet utilization, and reduce demands upon limited capital through 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 "normal" mortgage loan would have a 30 year term. In a world without government guarantees, the 30 year mortgage would likely still exist, but with lesser availability and presumably higher cost, due in part to issues related to risk hedging.

#### **B. Agency Market Share Trends and Performance During the Crisis**

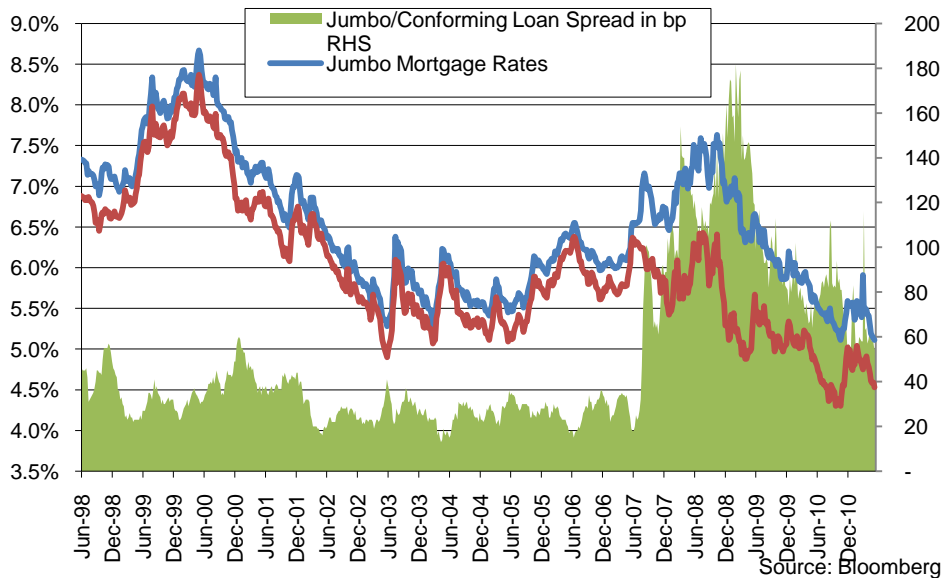
The chart below shows the ratio of agency MBS issuance to non-agency MBS issuance over the last 30 years. This chart clearly shows the reaction of the agency and non-agency markets to the financial crisis. Throughout the 80s and into the 1990s, the Agency share of the MBS markets was in the range of 80%. As the non-agency markets expanded in the mid-2000s, during the housing boom, the Agency share fell to approximately 50%. Therefore, even at the peak of the housing and securitization boom, the Agencies remained a critical participant in the MBS markets. As the non-Agency MBS markets collapsed in 2007 through the present, the Agencies took on a more critical role than ever, in terms of providing funding for mortgage lending to consumers. The Agency market was a stable source of funding throughout the crisis.

**Agency Market Share Pre and Post Crisis**



Source: SIFMA, Fannie Mae, Freddie Mac, Ginnie Mae, Federal Reserve

Another issue to review is the cost of a conforming loan (a loan eligible for securitization by a Agency) versus a non-conforming loan. The chart below compares the spread between conforming loan rates and non-conforming loans with balances that exceed the conforming loan limit. During the financial crisis of 2008, the spread between conforming and non-conforming mortgage rates increased to approximately five times its historic level, and pricing on non-Agency MBS relative to Agency dropped precipitously. The spread between these rates spread has yet to return to its historic trend.

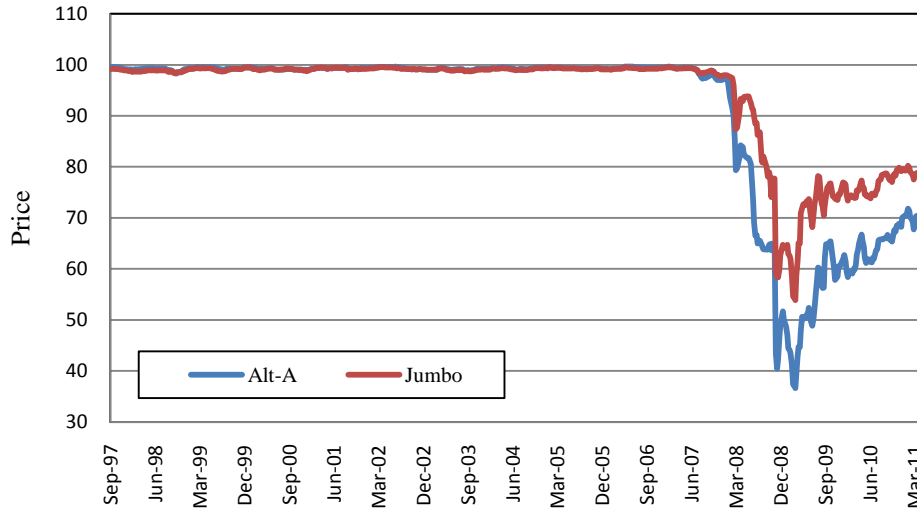


Source: Bloomberg



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**Non-Agency MBS Market Pricing Relative to Agency MBS, 1997-2011**



Source: Barclay's Live

From these charts, you can clearly see that we need to reduce the share of lending funded through the Agencies. Over the long run, it is not healthy for the government, in one way or another, to support 95% of mortgage lending. SIFMA therefore agrees that housing finance reform is critical, and supports its careful implementation.

At the same time, we believe that it is important to keep in mind that the Agencies have conferred significant benefits on U.S. mortgage markets. We believe that housing finance can and should be reformed and made more robust without destroying the benefits that the Agencies have conferred. We caution that the drive for reform should not cause collateral damage that would eliminate or make impossible the beneficial impacts and legacy of the old system that developed around the Agencies.

One of the most important benefits of the system developed over the previous decades, if not the most important, was the development of a liquid forward market for mortgage backed securities known as the TBA market. The TBA market allows lenders to hedge risk, attracts massive amounts of private capital, and reduces the cost of mortgage lending. SIFMA believes the TBA market should be a key component of 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 markets described above for Agency MBS are initiated by the TBA mechanism.

#### **D. The TBA Markets**

##### **A. History**

The genesis of the TBA market began in the 1970s, when members of the Government Securities Dealers Association began to discuss standards for the trading and settlement of bonds issued by Ginnie Mae. In

1981, the Public Securities Association<sup>2</sup> published the “*Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities*”, which is a manual that contains numerous of market practices, standards, and generally accepted calculation methodologies developed through consensus discussions of market participants, that are widely accepted and used in the MBS and asset-backed security markets. The GSDA and PSA were predecessors of SIFMA.

Participants in the TBA market generally adhere to market-practice standards commonly referred to as the “Good-Delivery Guidelines”, which comprise chapter eight of this manual<sup>3</sup>. These guidelines cover a number of areas surrounding the TBA trading of agency MBS, and are promulgated by and maintained by SIFMA, through consultation with its members. The purpose of the guidelines is to standardize various settlement related issues to enhance and maintain the liquidity of the TBA market. Many of the guidelines are operational in nature, dealing with issues such as the number of bonds that may be delivered per one million dollars of a trade, the allowable variance of the delivery amount from the notional amount of the trade, and other similar details.

**B. Mechanics of a TBA Trade**

The majority of trading volume in the agency MBS markets today is in the form of 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 could call up Market Maker A on May 23, and order \$10 million FNMA 5.5% coupon 30-year MBS, for settlement on July 14. *The investor does not specify specific bonds or CUSIP numbers.*

<sup>2</sup> The Government Securities Dealers Association and the Public Securities Association are predecessor organizations of SIFMA.

<sup>3</sup> The Good Delivery Guidelines are a part of SIFMA’s *Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities*, which is available here: <http://www.sifma.org/research/bookstore.aspx>

On July 12, according to market practice, Market Maker A would notify Investor A of the specific identities of the pools that will be delivered on July 14. Most likely, these will be MBS that were just issued at the beginning of July.

On the other side of an investor or market maker often stands a loan originator. Originators 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 to make decisions on when to lock in a rate for a borrower.

### **C. Key Benefits of the TBA Markets**

#### **1. Liquidity for U.S. Mortgage Lending**

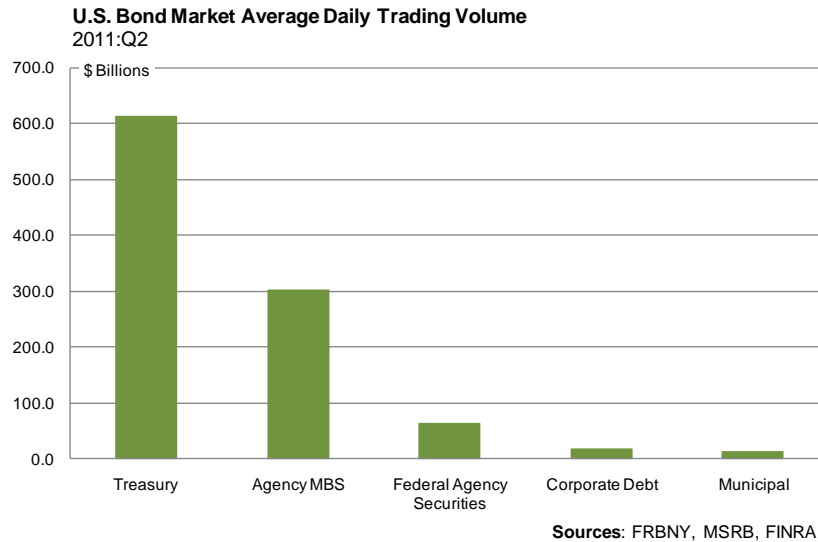
The TBA market is by far the most liquid, and consequently the most important secondary market for mortgage loans. This liquidity is derived from its vast size (\$trillions), homogeneity of collateral, and the forward nature of the trading. This liquidity is due to one factor: homogeneity. TBA trading 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. The sources of this homogeneity are primarily threefold:

- The Agencies each prescribe standard underwriting and servicing guidelines (FHA plays this role in concert with Ginnie Mae in those markets)
- Standardized market practices and guidelines (the “Good Delivery Guidelines”, discussed more below) ensure that securities eligible for the TBA market are homogeneous, which allows buyers and sellers to transact with confidence that knowing the specific identity of a security they will trade, at the time of trade, is not necessary;
- The explicit or implicit guarantee on the MBS eliminates credit risk from the risk factors investors must deal with. This guarantee also attracts classes of investors who would not otherwise participate in these markets; investors who are statutorily prohibited from, blocked by investment guidelines from, or simply do not desire to take on mortgage credit risk.

Thus, investors can buy securities without knowing their exact identity because they know that (1) the underwriting will be consistent across pools, (2) the servicing will be consistent across pools, (3) the MBS and operational mechanisms around their trading will be consistent across pools, and (4) they do not need to perform a loan-level dive to explore credit risk before they purchase the bonds.

There are currently over \$4 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.



This liquidity draws trillions of dollars of investment capital to U.S. mortgage markets, as discussed in detail in the previous section of this testimony. Given the size and liquidity of the market, buyers and sellers are able to trade large blocks of securities in a short period of time without creating distortions.

## 2. Originator Hedging and Rate Locks

As mentioned, this market allows lenders to sell their loan production on a forward basis, in some cases before MBS pools are formed, and hedge risk inherent in mortgage lending. A benefit of this ability to hedge risk is that the TBA market allows lenders to lock-in rates for borrowers. Lenders can sell forward in the TBA market at the then-current interest rate. Without TBA markets lenders would either have to charge substantially more for (probably shorter-term) rate locks, because hedging in derivatives or options markets is more expensive and less efficient. It is possible that some lenders simply would not offer rate locks at all. The liquidity of the TBA market creates efficiencies and cost savings for lenders that are passed on to borrowers in the form of lower rates and broad availability of mortgage products, and helps to maintain a national mortgage market.

## 3. Benchmark Status of the TBA Market

For all of the reasons outlined above, the TBA market is a benchmark for all mortgage markets – it is the reference by which other mortgage markets and products are priced. In this manner it is similar to the Treasury market. This is an issue that is often overlooked, but one that we want to highlight. Non-agency mortgage product is priced relative to TBA; TBA provides a sort of risk-free reference point for those markets. Without the TBA market, we believe that non-TBA markets would be somewhat more volatile as pricing would become more



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challenging. We also note that predictions of the movement of mortgage rates in a world without TBA generally do not take into account this role. While the actual change in rates would be quite dependant on the exact contours of a mortgage finance system without TBAs, we suspect that the change may be greater than many currently believe.

It is difficult to exaggerate the consequences from a loss of confidence or liquidity in this market if a suitable replacement were not found. 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.

#### **E. Looking Forward -- Considerations for TBA Markets and the Future of Mortgage Finance**

There is no single “right answer” or any easy solution to the question of how to resolve the conservatorships of Fannie Mae and Freddie Mac and/or 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. 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 and the restoration of the private-label securitization markets for mortgages.

Secondary mortgage markets will continue to function regardless of what policymakers decide. As the saying goes, there is a price for everything. This price, however, is not always desirable to everyone. 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. Among 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;
- the cost and affordability of mortgage credit to consumers.

SIFMA believes that the TBA markets are one of the keys to a successful, liquid, affordable, and national mortgage market. TBA markets also ensure that a sufficient level of capital is available to banks to lend. We repeat our previous statement: the historically huge and liquid global markets for Agency MBS are initiated by the TBA mechanism.

#### **1. Can the TBA Market Function without a Government Guarantee?**



Ultimately, the answer to this question is unknown. We are not aware of any meaningful, consistent TBA-style trading of any other non-guaranteed mortgage product at this time. To the extent that guarantees were completely removed, we believe that the best case outcome with respect to TBAs is a much smaller, much less liquid market. The worst case outcome would be the dissolution of the markets. But in the end, we do not know at this time.

As we mentioned earlier, the key driver of the TBA market is homogeneity. In the future, one can envision a recreation of “Good Delivery Guidelines” for a non-guaranteed product. However, this is only one piece of the puzzle. The Agencies play a critical role in the TBA markets through their standardization of underwriting and servicing, and their enforcement of that standardization through automated underwriting systems and otherwise. It is unclear to SIFMA how this could be recreated to the degree of detail at which it currently exists, and be done so in a format that was efficient and manageable enough to support liquid TBA markets.

The guarantee on MBS traded in TBA markets eliminates a key risk – credit risk. Investors in TBA markets focus on prepayment risk, that is, the risk that borrowers will repay their loans early, and on interest rate and market risk, or the risk that interest rates or market pricing will move against them. This allows what are called “rates investors” to invest in the Agency MBS markets. Rates investors, put simply, are investors who do not wish to take on credit risk. They include various investment funds, and importantly, many foreign investors.

In the non-Agency markets, investors must also deal with credit risk. This entails an examination of the credit risk factors of the loans that collateralize the MBS. Going forward, we expect that investors will perform this review at a loan level, as disclosure practices and regulations for non-Agency MBS drive to this end. In and of themselves, loan level reviews are not practical for TBA trading (because one cannot review loan level detail on an unknown pool of loans). Therefore, to create a level of comfort that would allow investors and market makers to trade non-agency collateral on a TBA basis, underwriting standards would need to be very strict because they would need to eliminate as much credit risk as possible. As a result, lenders would likely draw such a small circle around eligible mortgage loans that the supply of loans would likely not be sufficient to support large and liquid TBA trading. Additionally, to define the underwriting standards for every bank that would deliver into this market, and on top of that to outline servicing procedures, would entail a massive expansion of market practice guidelines in terms of breadth and length. This would complicate the ability of investors to get comfortable that the loans that underlie the securities they will be delivered next month, or the following month, will comply. Importantly, there would be no clear enforcement mechanism for compliance.

The expansion of the usage of mortgage insurance to provide comfort to MBS has been put forth as one alternative. SIFMA’s discussions with its members have evidenced significant doubts that the investing markets would take anything near the current level of comfort from private mortgage insurance solutions. In any case, members generally believe this solution would be inadequate to support liquid TBA trading.

Given all of this, it is not clear what proportion of the current rates investor base would shift into the proposed new non-guaranteed TBA markets. If a significant proportion of the rates investor base did not shift into the new market, the potential liquidity and potential size of the new market would be severely





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compromised (if it functioned at all). It is also not clear on the supply side whether or not a sufficient quantity of loans would be produced that would comply with the extremely strict underwriting guidelines that would be needed. It is notable that no other mortgage market or funding system via depositories has ever provided sustained liquidity to the extent that the Agency MBS markets have. It is also notable that each secondary mortgage market that was not the beneficiary of a guarantee collapsed in 2008.

SIFMA's Housing Finance Reform Task Force has concluded that some form of explicit government support is needed to attract sufficient investment capital to maintain liquidity and stability in the TBA market at a level comparable to that created over the last 30 years. Members believe that total privatization of mortgage finance will likely result in greater volatility, decrease efficiency, and ultimately make mortgage loans more expensive and less available. There are a number of ways that an explicit guarantee on MBS could be structured. The bottom line for a guarantee is that investors in TBA markets must know that they will receive back at least their invested principal. Without it, certain rates investors would completely drop out of the market and others would have significantly smaller allocations of investment capital available for the asset class, and we expect that at best, the peak volume and liquidity of such a market would be orders of magnitude smaller than the current TBA market.

Furthermore, as discussed above, Agency MBS currently provide a safe, liquid investment product for many risk-averse 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 could also have a negative impact on the performance of those investment vehicles in times of stress.

A related issue in many discussions of housing finance reform regards the appropriate number of number of chartered GSE-like entities, with or without a guarantee. These would be organized by the government or by the private sector as co-ops or otherwise. Regardless of specific structural form, we note that an increase in the number of entities will not necessarily reduce risk, as the performance of each entity will be strongly correlated. They all will make the same bet on U.S. housing, and to the extent we have another national downturn, they all will suffer. Also, because of a lack of diversification, a given entity would be more exposed to regional economic downturns. Organizationally, we also see challenges in recruiting 10, 15, or 20 skilled management, and especially risk management, teams. Furthermore, to the extent a TBA market would be viable (see our discussion above); a larger number of issuers would serve to fracture liquidity into multiple smaller markets. Put simply, a trader can only monitor so many screens at one time, and a large part of the liquidity in a given market is derived from its size. To the extent that a larger number of entities is a desired policy choice, we think it will be critical to (a) have only one security issuer that (b) issues diverse pools collateralized by loans from all of the issuing entities (i.e., similar to Ginnie Mae's multi-issuer pools). This would create a larger, unified securities market to stand behind the more fractured front end of the system. This would minimize any regional differentiation in pricing, maximize liquidity, and maximize the benefit to consumers.

SIFMA believes that the current situation is undesirable and unsustainable and must be changed. We also believe strongly that private capital should stand in front of any backstop or guarantee on MBS. We note



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that it is a policy choice to decide the appropriate size of the TBA market. Our concern lies with the end result, and that the end result is liquid and beneficial to lenders, investors, and consumers.

## **2. The Importance of a Smooth Transition to the Future Housing Finance System, and the Recovery of Non-Agency MBS Markets**

The future of mortgage finance in the U.S. is a critical policy decision facing members of Congress. The impact of this decision will reverberate across the nation's housing markets, across financial markets, and across the economy. It is no exaggeration to say that the future state of the housing finance system is central to the future of our nation as a whole. Regardless of what Congress chooses, the transition from our delicate current situation to the future must be carefully considered.

We have discussed above SIFMA's view that the TBA market is central to the functioning of our mortgage markets. To the extent that Congress desires to create a new mortgage finance regime that makes this possible, SIFMA would strongly support doing so. It will be important to put in place the basic structures that are required, as we have discussed, to allow for a transition from one TBA environment to the next with minimal disruption to current securities or mortgage markets. Such a regime would allow for the preservation of a homogeneous mortgage market eligible for TBA trading.

To the extent that Congress decides to significantly pull back or completely eliminate the government support for mortgage lending and thereby significantly shrink or make impossible TBA trading, it will be important to create a smooth path from the current state, which is over 90% government supported, to the future state. Ultimately, as the government role is pulled back, something or a combination of things must fill in the hole in mortgage funding that will be left behind.

In either case the role of the Agency MBS market should and will shrink from where it is today. Likely the most critical of the components that will allow this to happen will be the reinvigoration of the non-Agency MBS markets. These markets, aside from a few small transactions, have been dormant in terms of their funding of new origination. The bottom line to get these markets going is that we must get to a point where issuers of MBS and investors in MBS see eye to eye on the value proposition. Investors must receive a return that meets their needs, and issuers must pay a cost that works economically. There are a number of obstacles in the path. For example, many investors suffered significant losses on holdings of non-agency MBS in the latter part of the last decade, and it will take time for confidence to be fully restored in those products. Mortgage demand from consumers, because of the depressed economy, has significantly dropped. Importantly, both investors and issuers face significant regulatory uncertainty in addition to and apart from of the issues presented by resolution of the conservatorships of Fannie Mae and Freddie Mac.

For example, servicing is a key component of the value proposition for non-agency MBS. At this time, the future regulatory regime for servicing is up in the air. Investors have identified a number of concerns with current and past practices, and the market expects that the current paradigm may see dramatic changes. However, no one is certain of the timing or scale of these changes, which creates significant uncertainty. A precedent-setting settlement of major servicers with the State Attorneys General is expected, but the scope and timing are unknown. FHFA is leading an important industry discussion of the potential for revisions to the compensation of servicers in Agency and non-Agency markets, but again, the end of the story is still being



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written. The SEC in 2010 proposed a major set of revisions<sup>4</sup> to rules that govern asset-backed securities, some of which were re-proposed<sup>5</sup>, and some of which have been finalized<sup>6</sup>, but the most critical elements are not yet final.

Another issue relates to recently proposed credit risk retention<sup>7</sup> and mortgage underwriting rules<sup>8</sup>. The three main issues here are risk retention, the definition of a Qualified Residential Mortgage (QRM), and the definition of a Qualified Mortgage (QM). Each of these items is open, and is expected to be finalized by regulators in the future. Risk retention rules by their nature will change the economics of many securitization transactions. In part, this is expected to help restore the confidence of investors in securitized products and therefore stands to provide a benefit to the securitization markets. On the other hand, this benefit must be balanced by the preservation of securitization as an economical funding alternative for lenders. However, certain proposed provisions found in the credit risk retention proposal, such as so-called “premium capture”, have raised concerns among many market participants as to their potentially devastating impact on the economics of, and therefore future of, many type of securitization transactions.<sup>9</sup>

We expect the final form of the QRM and QM definitions to essentially define the shape of the mortgage market after they become effective. We expect that there will be little or no lending that falls outside of the QM standards, given that significant liability may attach to such loans. SIFMA has advocated that the final rules delineating QM include a true, bright line, legal safe harbor so that lenders will be comfortable to originate, and secondary markets will be comfortable to purchase QMs in steady volumes. Many expect that mortgage rates on QRMs will be lower level than those of non-QRMs (to an extent that is unknown). Regardless of any individual decision with respect to QM and QRM, it is important that these regulations be closely coordinated and finalized in a manner where it is explicit to lenders and secondary markets what is, or is not, a QM or QRM.

There are also significant regulatory revisions being made to the permitted activities of banks, to global and national capital standards, to the activities of credit rating agencies, the process of obtaining ratings, and the usage of their ratings. These changes include the capital treatment of mortgage servicing rights, eligible assets for various liquidity and capital buffers, and more generally changes to the capital treatment of securitized products.

All of this contributes to a great uncertainty as to the size, scope, and liquidity of securitization as a funding tool for consumer credit. It is difficult for lenders and creditors to make long-term plans for how they want to run their lending programs and how they will fund them, and it is difficult for investors to know the terms on which they will be expected to invest. Key principles must be followed to resolve this uncertainty: (1) Regulatory changes must be coordinated and sequenced properly; (2) changes must be based on robust data

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<sup>4</sup> SEC's April 2010 Asset-Backed Securities rule proposal here: <http://www.sec.gov/rules/proposed/2010/33-9117.pdf>, SIFMA comment letter in response here: <http://www.sec.gov/comments/s7-08-10/s70810-79.pdf>

<sup>5</sup> E.g., rules related to asset-level disclosure, shelf eligibility, and disclosure in non-registered transactions reissued for comment on July 26: <http://www.sec.gov/news/openmeetings/2011/agenda072611.htm>

<sup>6</sup> E.g., disclosure related to repurchase demands: <http://www.sec.gov/rules/final/2011/33-9175.pdf>

<sup>7</sup> Credit Risk Retention NPR: <http://www.sec.gov/rules/proposed/2011/34-64148.pdf>, SIFMA's sponsor/issuer response: <http://www.sec.gov/comments/s7-14-11/s71411-79.pdf>, SIFMA's AMG response: <http://www.sec.gov/comments/s7-14-11/s71411-80.pdf>

<sup>8</sup> See proposal from Federal Reserve Board under Regulation Z that would require creditors to determine a consumer's ability to repay a mortgage before making the loan and would establish minimum mortgage underwriting standards: <http://www.federalreserve.gov/newsevents/press/bcreg/20110419a.htm>

<sup>9</sup> For further discussion of premium capture and its potential impact, see SIFMA letters referenced above



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collection and analysis; (3) changes must keep in mind the dual needs of any financial markets: investors must receive adequate returns, and issuers must be able to fund at affordable cost levels.

All of these changes that directly impact the non-Agency markets, and the goal of promoting the responsible resurgence of those markets must then be viewed in connection with the resolution of Fannie Mae and Freddie Mac, as they cannot be separated. One cannot come before the other – they must work together. The ultimate question, yet to be addressed, is that of the capacity of other forms of funding of mortgage finance, be they non-agency securitization, covered bonds, or new measures, to replace the support for mortgage lending that the government currently provides.

#### **F. Conclusion**

SIFMA greatly appreciates the opportunity to present this testimony today and we hope that it is useful and informative to members of the Subcommittee. SIFMA believes that the TBA markets play a critical role in the current housing markets, and have provided tremendous benefits to mortgage markets and consumers of mortgage loans. SIFMA therefore believes that TBA markets can and should play a role in the future housing finance system in this country. Regardless of the path chosen for mortgage finance, SIFMA believes it is critical to properly transition from the current market structure to the future. We stand ready to assist Congress in any way necessary.