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Invested in America

July 11, 2019

The Honorable Steven Mnuchin
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable Dr. Benjamin S. Carson, Sr., M.D.
Secretary
U.S. Department of Housing and Urban Development
451 7th Street S.W., Washington, DC 20410

The Honorable Dr. Mark A. Calabria
Director
Federal Housing Finance Agency
400 7th Street SW
Washington, DC 20219

Dear Sirs,

SIFMA[1] and our members are strong supporters of comprehensive reform of the housing finance system. We believe that the time is right, indeed overdue, for the Administration and Congress to work together to move Fannie Mae and Freddie Mac ("the GSEs") from their current temporary status to a permanent solution. We welcome the issuance of the *Presidential Memorandum on Federal Housing Finance Reform* on March 27, 2019,[2] directing your entities to conduct a broad review of our housing finance system, including the GSEs. In anticipation of your report we wish to submit the following views.

We are encouraged by the Administration's efforts to develop a comprehensive and permanent solution that includes working together with Congress to develop an approach that focuses the scope of the GSEs' operations, creates a robust capital base for the entities, protects taxpayers, and preserves the liquidity and benefits the GSE MBS market for the benefit of the consumers and economy today. SIFMA supports comprehensive housing finance reform that preserves the broad availability of a 30-year mortgage, facilitates the liquidity of the TBA market and its benefits to consumers, while also enhancing the protection of taxpayers and the resilience of the housing finance system.

We believe a general principle of any reform effort should be that liquidity in MBS markets, and in particular the TBA market, not be disrupted by reforms or the process itself. Today's MBS market

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[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. 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 http://www.sifma.org.

[2] Available here: https://www.whitehouse.gov/presidential-actions/memorandum-federal-housing-finance-reform/

functions well, to the benefit of mortgage borrowers and the economy. The liquidity of this market attracts a deep and diverse investor base. In turn, consumers benefit as vast amounts of capital flow from these investors, through the GSE MBS programs, to lenders and on to mortgage borrowers. As a result, loans are more available, and at a lower, less volatile cost because the TBA market functions smoothly. Importantly, the TBA market also provides mortgage borrowers the ability to lock in rates at low or no cost because it allows lenders to mitigate their interest rate risk.

We share the Administration's recognition of the importance of the U.S. housing market as it relates to the general economy, representing one-fifth of GDP and 35% of all private, non-financial debt in the US.[3] Were policy makers, including Congress, to act without appropriate consideration of the complexity of the housing finance system, the availability of mortgage credit could become more erratic and volatile with negative economic consequences.

Given the size and importance of the U.S. mortgage market, market participants are monitoring reform efforts closely. They react in real time, not necessarily waiting until the conclusion of a legislative or administrative process. Close attention is paid to any and all public statements and publications, and unintended consequences may arise. Great care must be taken in terms of both expectations and actions.

In particular, history has proven that global market participants do not fully understand U.S. policymaking. This was clear in 2008 when, despite assurances that the government was standing behind the GSEs, many non-US investors withdrew from the GSE market and focused instead on Ginnie Mae, where the guarantee was and remains explicit and clear.

In the event that a legislative process is not successful, it has been suggested that the GSEs could still exit their conservatorships. We believe that absent Congress and the President legislatively enacting an explicit guarantee applicable to the GSEs' existing and new MBS, and without the finality provided by comprehensive housing finance reform, moving the GSEs out of conservatorship and back into the private markets would dramatically heighten the risk of a liquidity disruption for existing and new MBS.

Further, our members believe that market participants will no longer consider an implicit guarantee, even if supported by the remaining --but limited-- PSPA, as equivalent to an explicit guarantee. As such, we believe it is reasonable to expect investors would once again question the commitment of the U.S. government to the GSEs and their MBS. In contrast to the desire to project a nearly explicit guarantee when the GSEs entered conservatorship in 2008, such a move without legislation may be considered by some an explicit non-guarantee.

As you know, GSE MBS investors are "rates" investors – they are interested in taking on interest rate risk. They are not "credit" investors interested in taking on the credit risk of the issuers and the borrowers. Due to the backing of the U.S. government, GSE MBS are a rates product. If GSE MBS loses its character as a rates product, or that character is diminished or called in to question, the market will reprice the securities as a credit product, which will negatively impact the cost of credit for mortgage borrowers, threaten the ability of the TBA market to function, and harm economic growth.

This is particularly important with respect to foreign investors in GSE MBS. Based on industry estimates, non-US investors may hold between $300-$400BN in GSE MBS, or roughly 5-10% of the market. We

[3] Source: Federal Reserve, Flow of Funds data.

believe these investors are likely to be the most sensitive to the nature of the guarantee of the MBS, and experience from 2008 showed that once these investors retreat, they are slow to return.

Furthermore, other investor types will have similar concerns if the guarantee of the MBS is called into question. Our members expect that some portion of domestic investors (65% of the market not including the Federal Reserve's holdings) may choose to exit the market while others may reduce their holdings. The reason for this is that some investors are limited to holding only government-guaranteed assets, while others greatly prefer such assets.

We believe that were the Administration to remove the GSEs from conservatorship without a legislatively enacted explicit guarantee funding costs for lenders would be significantly negatively impacted. As one example, many lenders are funded by repurchase agreement or "repo" facilities. These facilities would reprice if the GSE MBS became a credit product – advance rates that may be near 100% today would likely drop sharply (in line with other credit products), and lenders would find it more costly to operate a lending business. This cost would ultimately be borne by borrowers through higher costs on their loans or simply through lenders originating fewer loans.

Increasing GSE capital, while important to the stability of the market and critical to the safety and soundness of the GSEs, is neither a substitute for nor a replacement of a guarantee. Equity investors may be comforted by bank-like levels of capital at the GSEs. However, even substantial capital levels at the GSEs will require that credit risk be priced into the securities given that PSPA support is finite, and this will widen valuations and reduce depth, liquidity, and participation in the markets. We do not believe capital, even at very high levels, in and of itself can replace the guarantee. The GSEs will be looked at as separate credits, probabilities of default will be non-zero, and the MBS will not be perceived as the rates products it is today.

Moving the GSEs out of conservatorship without a guarantee may also undermine the single security, for which the GSEs have spent tremendous resources as a matter of government policy over the last six years. With the credit quality of each GSE subject to a separate analysis, it would be difficult if not impossible for investment managers to represent to their clients that exposures to both GSEs are one and the same, and we believe that some market participants would not be indifferent to which GSE's securities are delivered under a TBA contract. This would likely lead to more specified pool trading and a shift back to the pre-2019 regime of separate GSE TBA markets, albeit this time splintered into a third – the remnants of the UMBS market. Liquidity would decrease and the goal of UMBS undermined.

We believe that the credit ratings of the GSEs when moved back to the private sector without an explicit guarantee on their MBS would create additional concerns.[4] GSE debt and MBS issuances would likely face much stricter concentration limits than they do today which could greatly limit permissible exposures to the GSEs. Market makers would similarly have stricter limits on inventories of these lower rated bonds. This would further constrain liquidity of their MBS and reduce the benefit provided to consumers.

The resulting impact on the GSE's credit risk transfer programs (CRT) could also be negative. One of the primary reasons CRT has been so successful is that the GSEs are viewed as strong, reliable

[4] A Fitch Ratings analyst noted that "I think we would have to question whether the AAA rating that we have on the enterprises would still hold." See *"A $4 Trillion Risk Tied to Freeing Fannie and Freddie Could Hurt U.S. Homebuyers",* available here: https://webcache.googleusercontent.com/search?q=cache:tfITbGKC974J:https://www.bloomberg.com/news/articles/2019-06-14/a-4-trillion-risk-from-fannie-freddie-release-worries-investors+&cd=1&hl=en&ct=clnk&gl=us

counterparties. To the extent the GSEs are released in an unguaranteed state, they would be viewed alongside of their peers – mortgage insurers (MI) and non-bank RMBS issuers. Even if the GSEs were the most well capitalized MI or RMBS issuer, they would still be monoline private companies with a finite capital base and thus present increased counterparty risk. This would likely have similar impacts to those discussed above – investors needing to more deeply investigate counterparty strength and ability to perform on transaction provisions, and more carefully estimate the risk of default/non-performance. Allocations would likely be reduced. This would likely make risk transfer more expensive and harder to place.

SIFMA believes that moving the GSEs out of conservatorship without legislation risks undermining and materially disrupting TBA market which has served the entire mortgage finance system so well over the last 40 years. It risks increasing costs to borrowers while enhancing the procyclicality of the markets and increasing the risk of financial instability. We do not believe there is a compelling case at this time to take these risks – the system we have today works and we should take the time to fix it correctly. The downside risk is quite significant, and we do not believe there is a need to rush to an imperfect or partial solution that engenders significant risks to the economy.

Moving the GSEs out of conservatorship is a goal all should support, but not without Congress taking the necessary action to address the need for an explicit guarantee. In advance of that, the Administration can and should take more limited steps today to review and adjust the nature of the GSEs current business, their capital adequacy and resilience, and scope of operations.

We commend the Administration for pursing this review and look forward to working with you and Congress to achieve a workable solution that establishes a safe and stable housing finance system for the foreseeable future.

With kindest personal regards,

Kenneth E. Bentsen, Jr.
President and CEO