Testimony of Richard Johns

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Committee on Banking, Housing and Urban Affairs

Hearing on

Essential Elements of Housing Finance Reform

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Structured Finance Industry Group

http://www.sfindustry.org/

Chairman Johnson, Ranking Member Crapo, and Members of the Committee on Banking, Housing and Urban Affairs:

My name is Richard Johns. I am the Executive Director of the Structured Finance Industry Group, Inc. ("SFIG"), a trade industry education and advocacy group established in March 2013 that presently is comprised of over 160 corporate members from all sectors of the structured finance and securitization market, including investors, issuers, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. A key element of SFIG's mission is to educate and advocate on behalf of the structured finance and securitization industry with respect to policy, legal, regulatory and other matters affecting or potentially affecting the structured finance, securitization and related capital markets. It is with that mission in mind that I thank you for this opportunity to address the Committee regarding proposed housing finance reforms, including the role to be played by the government in the housing finance system and the importance of returning private capital to the mortgage market.

As this Committee continues its examination of potential reforms to our system of housing finance, SFIG welcomes the opportunity to provide commentary and analysis, particularly as it relates to the impact of various reform options on the securitization markets. Before I proceed, I want to acknowledge the effort of all those who are working to make reasonable but necessary reforms to the housing finance system.

SFIG believes that the reform process must proceed in a measured and deliberate way, and we appreciate the Committee's methodical approach in considering reforms that are so inherently critical to the U.S. housing market and the economy as a whole. As an organizing principle for this process, we suggest that there are three sequential stages that any reform effort should follow in order to preserve the TBA ("To Be Announced") Market. First, a conversion into a common TBA should be adopted, making Fannie and Freddie MBS fungible and therefore deliverable into a single TBA Market, eliminating current pricing and liquidity inefficiencies in the Agency Market.[1] Second, any reform legislation should provide for the creation of a single agency security that not only would facilitate the conversion and continued liquidity of legacy securities but also would promote a deep and liquid new-issue MBS market. Third, a common securitization platform should be established for the purpose of overseeing and maintaining the standardization of the market for government-guaranteed MBS. With that organizing principle in mind, SFIG believes that there are a number of issues that must be addressed in any reform process, specifically:

- An integral part of any reform will be to ensure the continued liquidity of the TBA Market, which is the most efficient and cheapest mechanism to enable a mortgage consumer to "lock in" the interest rate at the time when a mortgage loan is approved and thereby minimize the cost of borrowing. The TBA Market also creates efficiencies and cost savings for lenders that are passed on to borrowers in the form of lower rates. Currently, the TBA Market is reliant in part on the existence of government-guaranteed MBS, making it imperative that any reform legislation include provisions that preserve some form of a government guarantee.
- The best approach to risk sharing in a reformed housing finance system would be for private capital to assume the first risk of loss, the proper amount of which should be flexibly assessed in light of market factors, while retaining an explicit government backstop against catastrophic loss. The retention of the catastrophic government

[1] In order for a common TBA to be implemented successfully, a number of issues need to be considered and addressed, and SFIG believes originators, financial intermediaries and investors must play a major role in that process.

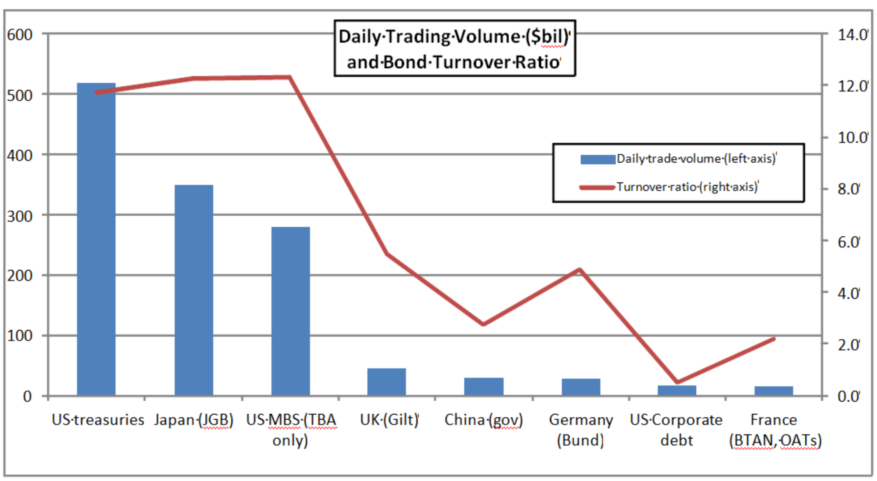
guarantee is critical to ensuring the continued participation of institutional "rate investors," which provide a majority of the capital currently invested in the Agency Market.

- The transition from the status quo to a new housing finance structure must be transparent, appropriate to market conditions, and handled with great care to minimize any disruptions to the flow of credit to consumers, and in particular to ensure the continued functioning of a healthy TBA Market. Of utmost concern is that steps must be taken to allow the fulfillment of existing commitments (including contracts for future delivery) and preserve the market for legacy securities (*i.e.*, outstanding government-guaranteed MBS), while allowing sufficient time for eligible loans under the reformed system to be generated and take hold in the TBA Market. SFIG believes that the best way to facilitate this transition would be to create a single agency security to which legacy securities would be converted and which Fannie and Freddie could begin issuing even before a single securitization platform is fully functional. This would allow for cost savings as well as greater liquidity in the TBA Market. Failure to take such steps not only would discourage investors from participating in both the leftover and post-reform TBA Market, but it also would create substantial mortgage funding issues.
- Any new infrastructure for the housing finance system must provide for or facilitate the standardization of MBS instruments that receive an ultimate government guarantee in order to ensure the continued functioning of the TBA Market. Standardization is critical to maintaining the fungibility and liquidity of the government–guaranteed MBS that drive the TBA Market.

- Any reform legislation should leave to regulators, working with market participants, the determination of the specific types of representations, warranties, enforcement provisions and recourse to be used in the new housing finance system.
- With respect to affordable housing, Congress should explicitly promote that goal through a stand-alone program not linked in any way to the operation of the secondary mortgage market, and should fund that program through separate legislative mechanisms.
- Conversely, Congress should reduce the upper loan limits for government-guaranteed loans to ensure that the benefits of low-cost mortgage loans are directed at the segment of the population most in need of those loans.

REFORMS MUST PRESERVE THE SMOOTH FUNCTIONING OF THE TBA MARKET.

As shown in the chart below, the TBA Market is the third most liquid securities market in the world.[2]



2 Sources: Securities Industry and Financial Markets Association; UK Debt Management Office; FRG Finance Agency; Japan Securities Dealers Association; AsianBondsOnline.com; Agence France Trésor Monthly Bulletin.

Moreover, more than 90 percent of government-guaranteed MBS trading volume occurs in the TBA Market. Accordingly, any reforms must be complemented by steps to ensure the TBA Market's continuing efficiency and liquidity.

The TBA Market creates efficiencies and cost savings for lenders that are passed on to borrowers in the form of lower rates. It also is the most efficient and cheapest mechanism to enable a consumer to "lock in" the interest rate at the time when the loan is approved, rather than take the risk that interest rates will rise between approval of the loan and the closing of the loan, which would increase the cost of the mortgage loan to the consumer and possibly make it unaffordable. The TBA Market does this through a system of forward trades of mortgage loan pools for guaranteed MBS that facilitates the shifting of interest rate risk into the capital markets. Thus, originators can offer consumers this ability to "lock in" mortgage rates by hedging the risk that interest rates will rise between application and closing. In this way, the TBA Market allows for stability between the time of loan origination and loan closing, ensuring that the terms of a mortgage loan do not fluctuate due to macroeconomic changes and reducing costs to consumers.

The distinguishing trait of trades in the TBA Market is their homogeneity (*i.e.*, standardized underwriting criteria and loan features, the government guarantee, the geographic diversification incorporated into the pooling process, the limited number of issuers, the simple structure of "pass-through" security features, and the restriction of the range of interest rates on loans deliverable into a single security). The parties to the trades agree only on certain criteria of the securities to be delivered: issuer, maturity, coupon, price, par amount, and settlement date. The actual securities to be delivered at trade settlement are not specified on the date the transaction is executed. Rather, just before the settlement date, the seller notifies the buyer of the specific securities that will satisfy the TBA agreement.

Because TBA buyers are indifferent as to the specific securities delivered, originators are able to easily and inexpensively cover their hedges should they originate less collateral than expected in any given period, significantly reducing the cost to hedge and rate lock. Moreover, since the TBA Market simplifies the analytical and risk management challenges for participants, a broader group of investors participates in the TBA Market than would otherwise participate if investment decisions were more complex. The additional investors—specifically foreign central banks, mutual funds and hedge funds—inject more capital into the market for financing mortgages and ultimately reduce the cost of capital to consumers.

Homogeneity is what makes the TBA Market possible, specifically, the fungibility of the conforming loan product (through standardized underwriting criteria and loan features) and a government guarantee, which equalizes credit risk. Additionally, due to the specific exemption from SEC shelf registration requirements applicable to government-guaranteed securities, specific collateral need not be identified, thus allowing forward selling. It is not possible to replicate the TBA Market without these factors. Any reform which does not accommodate, or suitably replace, the existing TBA Market will undoubtedly impact mortgage originators and consumers both severely and negatively by reducing price transparency, liquidity, and the originators' options to rate lock and thus satisfy consumer needs.

In short, the TBA Market removes uncertainty from the mortgage origination business and keeps mortgage rates low for potential borrowers. As noted in a report published by the Federal Reserve Bank of New York, "the TBA market serves a valuable role in the mortgage finance system," and "evaluations of proposed reforms to U.S. housing finance should take into account potential effects of those reforms on the operation of the TBA market and its liquidity."

TBA Trading and Liquidity in the Agency MBS Market, James Vickery and Joshua Wright, FRBNY Economic Policy Review, May 2013.

One factor that any reform must account for is that the TBA Market is reliant in part on the existence of MBS that are guaranteed by the government. For that reason, the TBA Market is extremely sensitive to any changes to the role that the government will have in the housing finance system going forward. Indeed, the TBA Market could not be recreated without the features discussed above that are unique to government-guaranteed MBS. Accordingly, SFIG believes that the maintenance of a partial, second-loss government backstop against catastrophic loss for MBS is crucial to preserving the health of the TBA Market and continuing to promote stability and affordable interest rates for consumers in different market cycles.

THE HOUSING FINANCE SYSTEM WORKS BEST WHEN THERE IS RISK-SHARING AMONG PARTICIPANTS.

Mortgage securitization is by nature a process by which the risks associated with residential mortgage lending are spread among various investors with differing appetites for risk. Attracting private capital to undertake these risks is of critical importance to the consumer and the economy as a whole. The government has always guaranteed a large percentage of residential mortgage securitization, but historically the market also included securitizations funded solely by private capital with no explicit government guarantee. These two markets cater to two different types of investors distinguished by the type of risk that each is willing to undertake, specifically, “rate risk” and “credit risk.” For this reason, any reforms that aim to limit the government’s involvement in the Agency Market by changing or ending the current infrastructure must account for the impact that such changes will have on the flow of private capital that historically has favored government-guaranteed MBS.

As noted, there are two main risks associated with residential mortgage lending. The first, called market or rate risk, results from interest rate changes. After the interest rate on a residential mortgage loan is set (for example, the interest rate on a fixed rate residential mortgage), that mortgage loan becomes less valuable over time if current residential mortgage rates rise, because the owner of that mortgage loan earns less in interest than it would if it owned a mortgage loan at the current (higher) market rate of interest. In addition, a consumer generally has the right to prepay his residential mortgage loan at any time (for example, if the consumer decides to sell the home), which may reduce the economic upside to the owner of the mortgage loan. Furthermore, refinancing of residential mortgages generally occurs when interest rates fall. The specific market risks associated with owning residential mortgage loans are dependent on the precise terms and types of mortgage loans.

The second risk associated with mortgage lending is credit risk. Credit risk consists of two components: (1) default risk; and (2) loss severity risk. Default risk is the risk that the consumer fails to repay the loan. Loss severity risk is the risk that, after a consumer defaults, the lender will not recoup all of the principal lent and the expected interest on that principal.

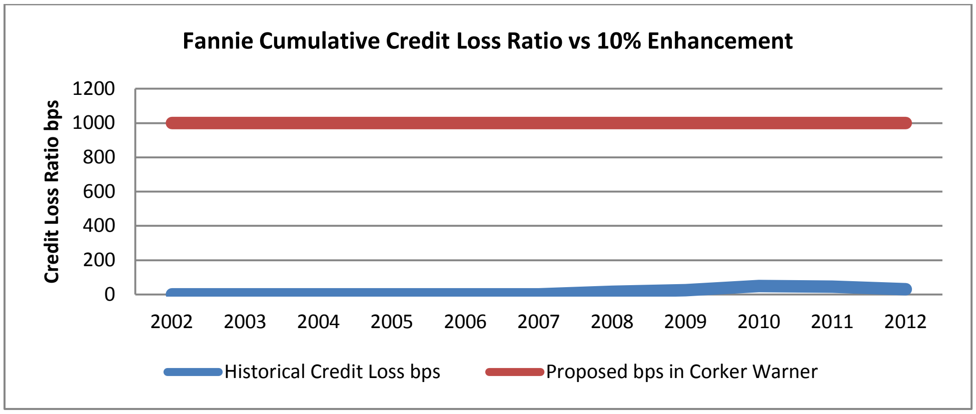
Private capital "rates investors" are willing to bear the rate risk and prepayment risk, but seek to avoid credit risk, because these investors operate under investment guidelines, capital requirements, and liquidity requirements that preclude them from purchasing private-label securities in any significant concentration. Examples of rates investors are foreign central banks, domestic banks and mutual funds. Historically, "rates investors" have been attracted to government-guaranteed MBS—in which the government bears the bulk of the credit risk—and they have contributed trillions of dollars to the Agency Market because of those guarantees. By contrast, "credit investors" such as insurance companies and investment funds have fewer constraints on taking credit risk, and may in fact actively seek it out in exchange for higher potential returns.

Limiting the government's involvement in the market by changing or ending the current infrastructure must account for the critical contribution that rates investors make to the Agency Market and their historic aversion to credit risk, as well as the limited pool of private capital available to fund credit risk. Accordingly, SFIG believes that retention of a catastrophic-loss government backstop is essential to maintaining and increasing the participation of rates investors in the Agency Market. Indeed, SFIG believes that the TBA Market and the rates market for MBS cannot function without such a guarantee.

However, we also acknowledge that private investors have a role to play in insuring against the credit risks posed by residential mortgages. To that end, SFIG generally supports the approach of having private capital take on credit risk, while also having a government guarantee that is explicit and priced in a reasonable manner. Any risk-sharing structure should be carefully reviewed to ensure that the TBA Market is not disrupted. Furthermore, we believe that private capital should be placed in the first-loss position, with the private credit enhancement being calculated to cover reasonable risks presented by the market and the government backstop covering catastrophic risk, *i.e.*, the government guarantee will generally be called upon only when the operation of the secondary mortgage market as a whole is at risk.

SFIG supports a variety of mechanisms to bring private capital into the mortgage market, including corporate guarantees and capital markets transactions. Various forms of capital should be allowed to compete on a level playing field that balances sufficient risk retention at each step of the origination process to align incentives with the separation of functions and responsibility necessary to attract diverse capital sources.

As for the amount of risk that a private investor should be required to assume, SFIG believes that the 10% first risk of loss provided for in S. 1217 is too high, as shown in the chart below.[3]



We suggest that, if the Committee is determined to include some minimum level of risk assumption in the legislation, the level be considered a "target" that the Committee establishes based on underwriting-related factors, such as historical loss data in the TBA market. Furthermore, the regulators should have the discretion to deviate from the target based upon their own assessment of qualitative risk factors.

The regulators will have to take a variety of complex factors into account to ensure that the private credit enhancement is rationally sized at a level that is commensurate with the qualitative attributes of risk-sharing structures. These factors include readily available historic information, the likely loan types, general housing/economic indicators, any applicable representations and warranties, and whether the various forms of insurance and guarantees—*e.g.*, the combination of homeowner's equity and mortgage insurance, Mortgage Insurance Fund coverage, and the government catastrophic guarantee—may be duplicative and overlapping due to counterparty risk, thereby reducing the amount of risk that private investors should assume.

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[3] Source: Securities Industry and Financial Markets Association, *Housing Finance, September 2013,* at 10.

We believe that if the required private credit enhancement is too high and vastly exceeds the loss expectations of the associated assets, the redundant enhancement creates the potential for distortion. Originators must find a way to pay for the enhancement, and the available options may not be good for the consumer or housing market. For example, an originator may simply pass the cost of the redundant enhancement directly through to consumers via increased rates, thereby undermining one of the primary benefits that the Agency Market affords consumers, namely, lower cost loans. And even if such steps are taken, the possibility remains that there might not be sufficient private capital in the market to satisfy a private credit enhancement level that exceeds what is necessary to address the actual risk factors.

THE TRANSITION TO A NEW HOUSING FINANCE STRUCTURE SHOULD BE IMPLEMENTED GRADUALLY AND WITH GREAT CARE.

The transition from the status quo to a new housing finance structure must be handled with great care to minimize any disruptions to the flow of credit to consumers. The transition process should be carefully implemented, and to avoid severe market disruption should allow for: (1) a clear and transparent plan for transition; (2) a determination that market conditions are appropriate for the transition; (3) the fulfillment of existing commitments (including contracts for future delivery); (4) a determination that issues relating to legacy securities have been appropriately handled; (5) time to generate eligible loans; (6) testing or piloting the new structure in a real market environment; and (7) continuation of the TBA Market.

SFIG's primary transition-related concern centers on ensuring that whatever system is put in place, it performs and functions properly and continues to facilitate a robust TBA Market. It is imperative that steps be taken both to preserve the market for legacy securities (*i.e.*, outstanding government-guaranteed MBS), while allowing sufficient time for eligible loans under the reformed system to be generated and take hold in the TBA Market. Otherwise, the post-reform TBA Market will stall as: (1) investors in legacy securities are left with orphaned securities that continue to lose value as they factor down and their market becomes smaller and smaller; and (2) the market for new agency securities takes time to ramp up.

SFIG believes that the surest method of facilitating a smooth transition is to allow for a conversion mechanism such that existing government-guaranteed MBS are interchangeable with the new government-guaranteed MBS. Fannie and Freddie could begin issuing a single mortgage-backed security even before the single securitization platform is fully functional. This would allow for cost savings as well as greater liquidity. Failure to take this step not only would discourage investors from participating in both the leftover and post-reform TBA Markets, but it also would create substantial mortgage funding issues as liquidity diminishes.

SFIG also believes that all market participants would benefit to the extent that the current and new infrastructures operate in tandem for some period of time, or, in the alternative, appropriate portions of the current infrastructure are utilized by the new infrastructure. In addition, a final wind down of Fannie and Freddie should happen only after the new framework has been sufficiently tested and we can all be confident that it will facilitate the continued functioning of the TBA Market.

We believe that these and other operational and delivery issues that will arise from the winding down of the existing framework and the ramping up of the new framework should be minimized by actively engaging directly with the relevant industry participants to determine the appropriate balance of regulatory discretion and legislative guidance regarding how the transition should proceed, as well as maintaining consistency (to the extent feasible) among the MBS issued across the platforms.

STANDARDIZATION IS ESSENTIAL TO THE FUNCTIONING OF THE REFORMED TBA MARKET.

Any new infrastructure for the trading of government-guaranteed securities will necessarily include requirements for areas such as disclosure, documentation, data collection and overall standardization of government-guaranteed MBS transactions. Indeed, standardization of documents (*e.g.*, standard government loan forms), structuring and underwriting (*e.g.*, conforming loan limits, document verification, etc.) is critical to the TBA Market because it increases fungibility and liquidity of government-guaranteed MBS. These requirements should be very transparent, take into consideration the needs of all parties to the transactions, and include investor protections. Important to this standardization of the market will be establishing common infrastructure in the form of a common securitization platform that will lower barriers to entry for new participants into the system and enable different entities to issue a single security without variation.

We would also caution that standards and practices that may or may not be appropriate for the new government-guaranteed securities may not be appropriate for private-label securities given the wide variety of loan types, origination practices, servicing contracts, deal structures and the difference in negotiating power of transaction participants. The newly reemerging private-label RMBS market should not be expected to align completely with the rules and standards that are developed for the new government-guaranteed securities. As noted above, the two markets cater to two different types of investors.

LEGISLATION SHOULD NOT SPECIFY THE TYPES OF REPRESENTATIONS AND WARRANTIES TO BE USED IN THE NEW HOUSING FINANCE SYSTEM.

We do not believe that language specifying the types of representations, warranties, enforcement provisions and recourse to be used in the new housing finance system should be prescribed in legislation. Rather, these are matters that should be left to the discretion of regulators. SFIG is actively focused on evaluating different representation, warranty, enforcement and recourse approaches that have arisen in the private-label RMBS market. We have also begun a dialogue with regulators and agencies regarding this topic to explore how the government might incorporate our analyses into its current efforts. Areas of particular interest include common securitization platform, secondary market viability of loans that do not meet Qualified Mortgage-Safe Harbor and Qualified Residential Mortgage standards, Regulation AB 2 proposals and due diligence, data, breach, repurchase and other disclosures.

Affordable Home Ownership Should Be Pursued Through A Separate, Explicit Program Dedicated To That Goal.

SFIG agrees that all segments of American society should have the opportunity to become home owners and that the government can and should play an important role in making that goal a reality. However, we do not agree with the current system, which has led to implicit subsidies in the form of purchases of subprime loans from noncreditworthy consumers. Instead, SFIG believes that Congress should explicitly promote affordable housing through a stand-alone program not linked in any way to the operation of the secondary mortgage market, and should fund that program through separate legislative mechanisms.

On the flip side of the equation, we also agree that the current upper limits for government-guaranteed loans should be reduced, to ensure that the market is focused on the segment of consumers for whom the government guarantee is most essential in obtaining reasonably-priced residential mortgages.

Conclusion

The issues confronting the Committee as it considers reforms to the housing finance system are critical not only to the health of the nation's housing market, but to the growth of the nation's economy generally. While we recognize the need to correct the errors of the past, we urge the Committee not to lose sight of the ways in which the Agency Market has worked well, and continues to work well (such as through the TBA Market), to facilitate the ability of Americans to enjoy the benefits of home ownership. To that end, we encourage the Committee to strive to retain the mechanisms, such as the government guarantee, that have succeeded in bringing vast amounts of private capital into the housing market, while it takes steps to more equitably and effectively distribute the risks related to residential mortgages.

We look forward to working with the Committee as it considers these vitally important issues. Thank you again for the opportunity to share SFIG's views.