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On behalf of the Securities Industry and Financial Markets Association

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Chairman Johnson, Ranking Member Crapo, and members of the Committee. Thank you for the opportunity to testify before you today. My name is Michael Canter and I am Senior Vice President and Director of Securitized Assets at AllianceBernstein, testifying today on behalf of the Securities Industry and Financial Markets Association (SIFMA)[1]. SIFMA and its members look forward to working collaboratively with you all in analyzing how policy choices made will affect the ability of secondary mortgage markets to provide liquidity to lenders, and thus the availability and cost of credit to support housing finance.

Among other priorities which I will discuss, SIFMA and its members believe that the preservation of the ability of secondary markets to support the 30-year, fixed-rate mortgage should be a key priority. The 30-year fixed rate mortgage is a stable and predictable way by which most Americans have historically financed their home purchases. While adjustable rate and shorter-term mortgages have benefits of their own, the 30-year mortgage provides for an affordable and predictable payment for many borrowers. Such 30-year mortgages, however, present significant risks to lenders and investors in that the stream of interest income is locked in over a long period, regardless of where funding costs move. To manage this risk, lenders need access to a liquid, forward market for mortgage loans. Without such a market to manage interest rate risk, lenders would be less willing to originate 30-year fixed rate loans and many would likely not originate them at all.

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

Indeed, SIFMA's primary focus in considering reform of the housing Government Sponsored Enterprises ("GSEs") is the preservation of a liquid, forward market for the trading of mortgage-backed securities ("MBS"). Today, the "to-be-announced" ("TBA") markets serve this function. The TBA market serves a critical function in our current system, allowing mortgage originators to sell conforming loans before they are originated, enabling them to provide interest rate locks to borrowers well in advance of closing while hedging their risk. This allows the borrower the ability to lock in a rate well in advance of settlement. Furthermore, the TBA market provides the necessary liquidity that enables a national market whereby regional differences do not impact credit availability for borrowers in particular locations, as MBS traded in the TBA market tend to be geographically diverse. In addition to the loan origination aspect, the TBA market provides an important benefit to investors such as pension plans, 401(k) plans, mutual funds, state and local governments, and global investors. Indeed, with over $250 billion of securities traded on an average day, the TBA market is the largest and most liquid secondary market for mortgages, and second only to the U.S. Treasury securities market in terms of bond market activity.

Today's hearing asks this panel to consider the essential elements of a guarantee but to flip that a bit, an essential element of the TBA market is the guarantee itself. Homogeneity is what makes the TBA market succeed. In this market, buyers and sellers agree on certain terms of a trade, but importantly buyers do not know all of the specific characteristics of the security they have purchased until two days before the trade settles. This is what allows liquid forward trading, and allows originators to hedge production pipelines.

The homogeneity is driven by two main factors: standardization of terms, and the absence of credit risk. Terms are currently standardized through the GSE's lending, servicing, documentation and other guidelines. Credit risk is addressed though the implied but near-explicit government guarantee on the principal and interest payments of the MBS. A structure whereby private capital would take a first position loss with a limited government guarantee supporting losses beyond the first position loss would serve to diminish any credit risk concerns. This allows for what is essentially a one-factor analysis of the market – that of prepayment risk or the risk that borrowers will refinance or otherwise repay principal before it is due in response to changes in interest rates. It is a so-called "rates market", as opposed to a "credit market". The guarantee serves another beneficial function by attracting investors who would otherwise not invest in MBS.

Possibly the most important benefit of the guarantee is the support that it provides to the market in times of crisis – it allows investors to fund mortgage credit creation even at times when other markets become less liquid. This was tested in 2008, when private-label MBS markets completely shut down, bank portfolios significantly contracted lending standards, and the GSE and FHA markets took on the vast majority of credit provision. Without the guarantee, credit would have dried up as it did for corporations and other significant borrowers. And what mortgages could be sold would have been far, far more expensive. No one disagrees that the role of the government must shrink, but it must also be recognized the critical counter-cyclical role the guarantee plays.

Sharing Risk with the Private Sector

When thinking about the private capital that should stand in front of the guarantee, we believe that the risk that taxpayers are exposed to losses should be very remote and that risk should stand behind a number of levels of private capital acting as a shield or buffer. In arranging such a system, the various sources of private capital protecting the government should be recognized:

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

Introducing market-based risk taking into the system will confer an important benefit on the system. Global capital markets are often more able to accurately price mortgage credit risk than a government agency or regulator. Capital market participants also price risk on a relative basis, in comparison to other investment options, and this should help temper risks of a race-to-the-bottom. To the extent that mortgage risk becomes underpriced, participants should gravitate towards alternatives that provide more attractive returns, tempering the level of underpricing. Of course, this pricing of risk will not be perfect, and it will not necessarily in and of itself service whatever

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

goals policymakers may set forth. It will, however, provide critical signaling to the world as to exactly what level of risk taxpayers are taking on as they provide the ultimate guarantee for the new conforming MBS, and should promote a more safe and sound system.

A consideration here is that a mandatory, fixed level of risk sharing could contribute pro-cyclically to fluctuations in mortgage markets and credit availability. We could support an approach where mandatory levels of risk sharing fluctuate in relation to the demand for mortgage credit risk. If constructed otherwise, the regime will tend to exacerbate booms and busts. If there were housing market distress, risk would be more expensive to sell, and that would increase the cost of credit. Increases in the cost of credit could exacerbate housing market distress. This is not to say that it is inappropriate for mortgage rates to fluctuate due to economic or other factors, but rather that it is appropriate for policymakers to have levers to ease extreme periods of dislocation before they become systemic problems. Importantly, significant changes in the pricing of this risk will signal to regulators and policymakers that something is happening in mortgage markets that may warrant further study. One of the most important factors in considering how first-loss capital should be introduced into the markets for the new conforming MBS is whether or not a particular approach will disrupt the critically important liquidity of the TBA market.

Securities-based structures to take first-loss risk have important advantages and disadvantages. Some securities-based proposals involve a requirement that risk be shared with capital markets investors concurrently, or near concurrently, in order to obtaining a government guarantee. We note above that the TBA market provides important price information to lenders that allows them to hedge risk and provide rate locks to borrowers. To the extent that obtaining a government guarantee is conditioned upon the prior sale of a set amount of risk into private markets, advance price information may not be available to the lender because there is no liquid, forward market for mortgage credit risk. This will make it harder or impossible for lenders to provide rate locks to borrowers because the cost of the risk sharing is a factor in the pricing of the loan. This would likely cause significant problems for the liquidity of the TBA market, and could potentially render it inoperable. This implies that risk sharing requirements are better structured to not be a strict concurrent mandate with the issuance of a new conforming MBS – risk needs to be warehoused somewhere for a period of time.

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

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

Capital markets transactions similar to Freddie Mac's STACR or Fannie Mae's CAS series are viewed as the most viable currently used form of risk sharing with capital markets. Since these types of transactions do not impact security structure, they do not have an impact on the functioning of the TBA market. They are also flexible and should be able to accommodate various investor needs and strategies for sharing risk with them.[3] However, their performance through a cycle and ease of execution in less favorable market environments has not yet been observed. Other arrangements that do not alter security structure, such as the pool-level mortgage insurance transaction recently executed by Fannie Mae, also appear to be compatible with TBA.

There are similar considerations for models that involve private guarantors, especially regarding how many there should be. The range is from zero (i.e., FMIC is the guarantor in the

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

system) to one, two or a multitude of privately-owned entities. Advantages to a greater number of first-loss credit providers include the ability to optimize execution among competing pricing and eligibility criteria, insulation from operational failure of any single first loss credit provider, greater variety and more innovation in product offerings and more equal bargaining strength between the first loss credit provider and mortgage originator.

On the other hand, fewer first-loss credit providers would offer increased product standardization, enhanced liquidity for both loans and securities, and lower total cost of infrastructure. Due to the extreme correlation of their business models, the benefits of risk diversification stemming from larger numbers of first-loss credit providers are likely smaller than they may appear.

Finally, competition among first-loss credit providers creates a risk of "race to the bottom" pricing and guideline offerings. A similar issue also arises in Co-Op structures where members may attempt to gain market share or increase margins by making riskier loans and "free riding" by delivering them into the Co-Op's pricing, which is based on aggregate collateral performance. This argues for a focused effort to ensure that competition is promoted among guarantors and other parties. Barriers to entry should be limited to the level that is necessary to ensure a stable environment; regulatory standards should be high enough to ensure that incentives to "race to the bottom" are mitigated.

Transition Issues

As many have noted, the transition to whatever new system policymakers create is just as important as the new system itself. Put simply, the government should reform, repeal, or avoid policies that repel private capital or generate uncertainty. Private market participants demand transparency and certainty in their investments and capital allocations. Many factors and events during and stemming from the recent financial crisis have caused private capital to retreat from funding mortgage credit. In particular, the potential for seizures of loans through a municipality's use of eminent domain run the risk of causing private capital to once again flee the mortgage markets. Such actions, if they are allowed by policymakers to proceed, would damage investor confidence in mortgage markets and drive the cost of mortgage credit higher, and availability therefore lower. Policymakers must recognize the national importance of this and ensure that individual municipalities or other governmental entities are not able to cause damage and act in opposition to the national interest. Above all, federal government programs and entities such as the Federal Housing Administration should not be party to such activities.

The timeline for transition must be long enough to facilitate continual liquidity and flexible to accommodate unforeseen challenges. The transition will consist of changes to the legal and operational framework of the core of mortgage finance. The transition begins immediately with the implementation of the legislation, and continues with the development of guarantors and other capital market risk sharing and operational standards. Additionally, the expectations of current bondholders must be supported through clarification of guarantee for existing securities: Not making explicit the implicit guarantee on existing MBS and corporate debt will disrupt the markets for these securities, harm the confidence of investors who are needed to participate in the new market, and make impossible a seamless continuation of the liquidity from the current markets to the future markets.

In conclusion, as this Committee continues down this critical path towards establish a more sustainable housing finance system, SIFMA and its member firms stand ready to assist you and your colleagues in answering the tough questions that lay ahead.

Appendix – Primer on TBA Markets

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[4] 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[5]. 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.

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.* On July 12, according to market practice, Market Maker A would notify Investor A of the specific identities

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[4] The Government Securities Dealers Association and the Public Securities Association are predecessor organizations of SIFMA.

[5] 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

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.

Key Benefits of the TBA Markets

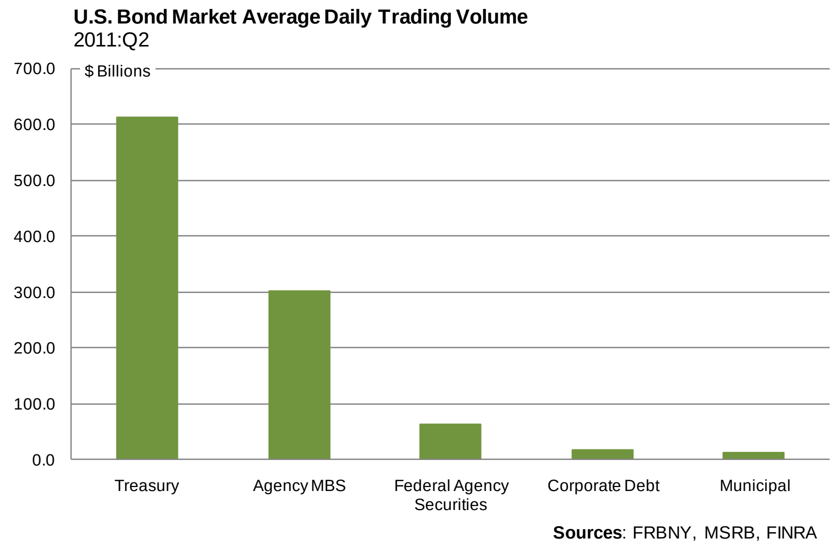
- Liquidity for U.S. Mortgage Lending

The TBA market is by far the most liquid, and consequently the most important secondary market for mortgage loans. This liquidity is primarily derived from the homogeneity of the MBS collateral, combined with its vast size (>$4 trillion) and the forward nature of the trading. 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.

- 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.

- 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 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 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.

Can the TBA Market Function without a Government Guarantee?

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 far smaller, far less liquid market. The not-unlikely worst case outcome would be the complete dissolution of the markets.

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 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 members have 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.