Testimony of

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Before the

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Hearing on

"The Future of Housing Finance—A Review of Proposals to Address Market Structure and Transition"

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Chairman Frank, Ranking Member Bachus, and members of the Committee, thank you for the opportunity to speak today on the future of housing finance, a subject that affects virtually every American, and not just homeowners. My name is Michael Farrell, and I run Annaly Capital Management. Annaly is the largest listed residential mortgage REIT on the New York Stock Exchange with a market capitalization of $11 billion. Annaly, together with our subsidiaries and affiliates, owns or manages over $90 billion of primarily Agency and private-label mortgage-backed securities (MBS). Additionally, we also are deeply involved in the mortgage markets through our securitization, structuring, financing, pricing and advisory efforts.

I am here today representing the secondary market investors who have historically provided the majority of the capital to the $11 trillion mortgage market, and my remarks are focused on that perspective. Debate over housing finance reform has largely been about government's role in it, and rightly so given that Fannie and Freddie's government-sponsored hybrid charter was ultimately disastrous for taxpayers. However, there are certain activities that these Agencies performed that are important to the pricing and liquidity of the housing and mortgage market.

The current housing finance system, certainly the one that prevailed until underwriting standards started to slip around 2004, is the most efficient credit delivery system the world has ever seen. There are important elements of the existing system that are worth keeping:

- First: securitization, where fully documented borrowers of similar creditworthiness using similar mortgage products are pooled and receive the benefits of scale in pricing.
- Second: the government guarantee to make timely payments of interest and principal on MBS that scales the process even further by making the securities more homogeneous.
- Third: the to-be-announced, or TBA market, which is what Fannie and Freddie and Ginnie facilitate. It is through the TBA market that most residential mortgages are pooled and sold, and it enables originators and investors to hedge themselves.

I believe that the market will adapt to whatever changes occur to these items in a new housing finance system. However, the market will adapt to the new structure by repricing it. If the new system has significantly different risk, uncertainty and friction than the housing finance system we have now, the consequences may be that our housing finance system is smaller with lower housing values and less flexibility and reduced mobility for borrowers. This can have ongoing and broad consequences for economic growth.

If mortgage rates and house prices were not an issue, the government would not have to be involved in housing finance. But these are important issues. Therefore, I believe a housing finance system that utilizes a government guarantee on well-underwritten mortgage securities would maintain the significant size and liquidity of the market, as well as continue to provide for relatively lower costs to the borrower. Going forward, however, the portfolio activities of Fannie and Freddie should be eliminated. The private market would expand its investment activity to fill this role, much like Annaly and its brethren do now. But it is important for the Committee to understand that the majority of Agency MBS investors ***finance their positions***, using financing that is available and priced where it is because of the government guarantee on the assets. Fannie and Freddie financed their portfolio purchases through the capital provided by the debt markets. This is an essential component of housing finance.

In any transition, Congress must consider the potential size of the market in the system to which we are transitioning, because about $8 trillion of the $11 trillion in home mortgage debt is funded by investors in both Agency and private label mortgage-backed securities. Of that $8 trillion, some 70% is held by investors in rate-sensitive Agency MBS, with the balance in credit-sensitive private-label MBS. There isn't enough capital for the universe of credit-sensitive private-label MBS investors to supplant the installed base of rates buyers, ***at least not at the current price***. Without the support of mortgage values and home prices that is provided by the government guarantee, the funding hole of $8 trillion will get smaller only by ***shrinking the value of the housing collateral and the mortgages needed to finance them***. At its essence, then, any transition to a new housing finance system has to factor in the speed with which these values will change.

In conclusion, I believe that Fannie and Freddie should continue to operate in conservatorship with a goal of winding down their retained portfolios over a set period of time and honoring the guarantees of the Agencies. For simplicity's sake, and the markets like certainty and simplicity, going forward Congress should consider delivering explicit government guarantees on MBS in a manner similar to Ginnie Mae. This would enable it to continue to serve as the portal between the borrower and the secondary market through securitization and the TBA mechanism, but most importantly enforce underwriting standards for mortgages carrying the government guarantee.

Thank you again for the opportunity to testify today, I look forward to answering your questions.

# # #

Appendix I: Annaly Capital Management's Submission to Treasury's Request for Input on Reform of the Housing Finance System, July 21, 2010

Introduction to Annaly:

Annaly Capital Management, Inc. (NYSE: NLY), one of the nation's leading investors in fixed income securities, is uniquely qualified to provide responses to the questions on housing finance posed by the Department of Treasury. We are primarily investors in Agency mortgage-backed securities (MBS) and, through our subsidiaries and affiliates, in non-Agency loans and mortgage-backed securities, but we touch the mortgage market in a number of different ways—asset management, securitization and structuring, financing, pricing and advisory work.

Annaly is the largest listed residential mortgage REIT on the NYSE with a market capitalization of approximately $11 billion and $70 billion in Agency MBS on its balance sheet. Annaly's principal business strategy since its inception in 1997 is to generate net income for distribution to investors from its portfolio of Agency MBS and from fee and service income earned by its two wholly-owned SEC-registered investment advisor subsidiaries, Fixed Income Discount Advisory Company (FIDAC) and Merganser Capital Management, Inc. (Merganser), and its wholly-owned broker-dealer subsidiary, RCap Securities, Inc. (RCap).

FIDAC is the external manager of two separately traded mortgage REITs, Chimera Investment Corporation (NYSE: CIM) and CreXus Investment Corp. (NYSE: CXS). Chimera, launched in November 2007, manages a portfolio of non-Agency residential mortgage loans and securities, and CreXus, launched in September 2009, invests in commercial real estate loans and securities.

Together, Annaly and its subsidiaries own or manage over $90 billion in assets (at March 31, 2010), have a wide range of public institutional and individual shareholders, and have the investment expertise, analytical focus, size, systems capabilities and track record to represent the perspective of investors in mortgage loans and securities.

Background on Annaly's Answers:

The Obama Administration is seeking public input on the future of the housing finance system, including Fannie Mae and Freddie Mac (the Agencies or GSEs), and the overall role of the federal government in housing policy. As we understand it, the endeavor is a step towards developing a system that avoids the critical events that contributed to the financial crisis of the last two-and-a-half years (including the missteps of Fannie Mae and Freddie Mac) and enables the housing finance market to achieve the policy goals of the US government once market conditions normalize. Specifically, the public input is intended to help the government determine the appropriate level of government involvement in housing finance, if any, while minimizing taxpayer risk.

This is not a straightforward exercise. The housing finance system in the United States has largely been a success story, and changing it won't necessarily improve it. Creditworthy borrowers—those with a pattern of good credit behavior, money for a down payment, and full documentation—have generally been able to access mortgage credit on essentially the same terms and conditions regardless of where they live in the US. In effect, this has created a national housing finance system and borrowers are not disadvantaged by the vagaries of local credit conditions. With the advent of securitization technology, the secondary market of mortgage investors has developed into a deep and global market that has generally worked to the advantage of the average American homebuyer. The liquidity that Fannie Mae and Freddie Mac provide, both through their MBS guarantees and through their own balance sheets, has been an important component of this system, and not just for the conforming borrower. Indeed, a conforming borrower has generally paid a lower rate than a jumbo prime borrower, but the conforming mortgage rate also serves as an effective benchmark for other mortgage rates.

It has not been a perfect system, however, and its flaws became most evident beginning in the first decade of this century. These flaws are well-documented and include (but are not limited to):

- Fannie Mae and Freddie Mac, as private companies with public policy charters, served two masters. They pushed for profitability for shareholders to the detriment of their government charters by increasing their leverage and lowering their own underwriting standards. In the end, they achieved their charter objective, but they failed both masters.
- Mortgage originators ignored prudent underwriting standards and unleashed a flood of affordability products on unwitting and unqualified borrowers.
- Mortgage borrowers misunderstood or ignored the risks of the affordability products.
- The financial engineers on Wall Street created CDO and SIV structures that fed unprecedented demand and embedded leverage on leverage.
- Ratings agencies used flawed models, included perpetual home price appreciation assumptions, to improperly rate the different cash flow tranches.
- Investors in both the senior tranches (including the GSEs) and the junior tranches exercised poor judgment in trusting that others on the assembly line (originators, rating agencies, underwriters) did their jobs responsibly.
- The socialization of credit risk around the globe infected virtually every financial institution.

The key to overhauling housing finance in America is to understand what was broken, then keep what worked and discard what didn't.

What didn't work is the Agencies' retained portfolio activities and poor underwriting standards in the broader mortgage marketplace. The retained portfolios of Fannie and Freddie were managed at significantly high levels of leverage given the risk they were taking on. The portfolios were designed by the creators of the GSEs to be a tool for providing market liquidity when credit was freezing up, to keep credit flowing to the mortgage market. The typical sign that this was happening was spread widening in the secondary market, whereupon the Agencies stepped up purchases. Unfortunately, the GSEs were probably too liberal in their approach to this part of their mandate, and instead exploited any attractive arbitrage they could for profit. As Secretary Geithner said in his testimony to the House Financial

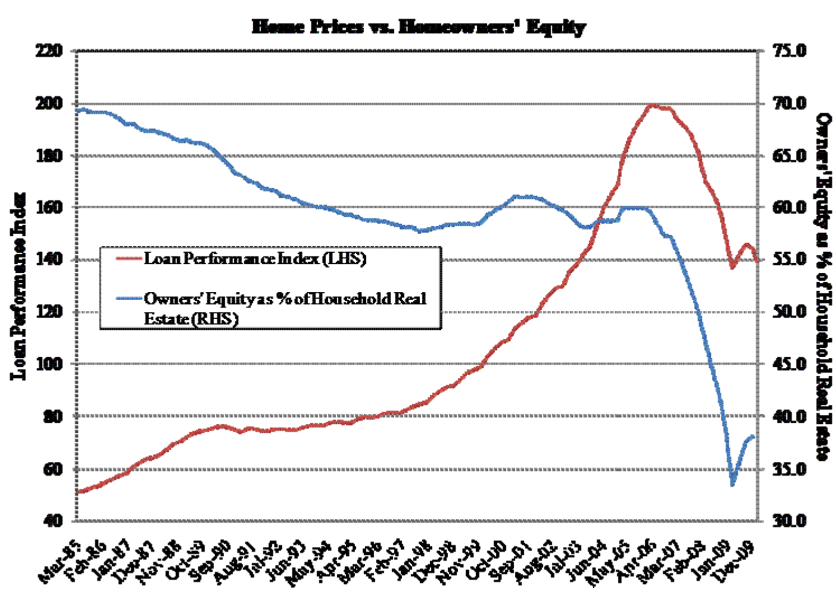
Services Committee, “The GSE charters contained a fundamental misalignment of interests. As private companies, the GSEs had a fiduciary duty to maximize profits. However, at times this duty conflicted with their public mission, which was relegated to a subordinate role.”

Responsibility for underwriting standards was abrogated by virtually everyone along the assembly line of MBS creation. This quote by William D. Dallas, founder and CEO of Ownit Mortgage Solutions, one of the many sub-prime mortgage lenders that went bankrupt during the crisis, epitomizes how far this went. He was asked why his company continued to lower lending standards even as the risks grew. “The market is paying me more to do a no-income verification loan than it is paying me to do the full documentation loans,” he explained. “What would you do?”

And as we know, the Agencies bought hundreds of billions of the triple-A tranches of MBS collateralized by these subprime mortgages for their retained portfolios, thereby enabling their creation.

We also want to make sure that this evaluation of the housing finance system is conducted in the proper context. Specifically, in the broad sweep of housing finance, we must focus on the period from 2003 to 2007, when anomalous practices occurred that led to the situation we are in today. In Figure 1, we see how the decline in home prices since the peak in 2006 has translated into a decline in home equity as a percent of household real estate, but home equity also declined during the greatest run-up in home prices in American history. This occurred due to the mortgage credit bubble that enabled homeowners to refinance, trade up to more expensive homes and extract well over a trillion dollars of equity during the 2002-07 period.

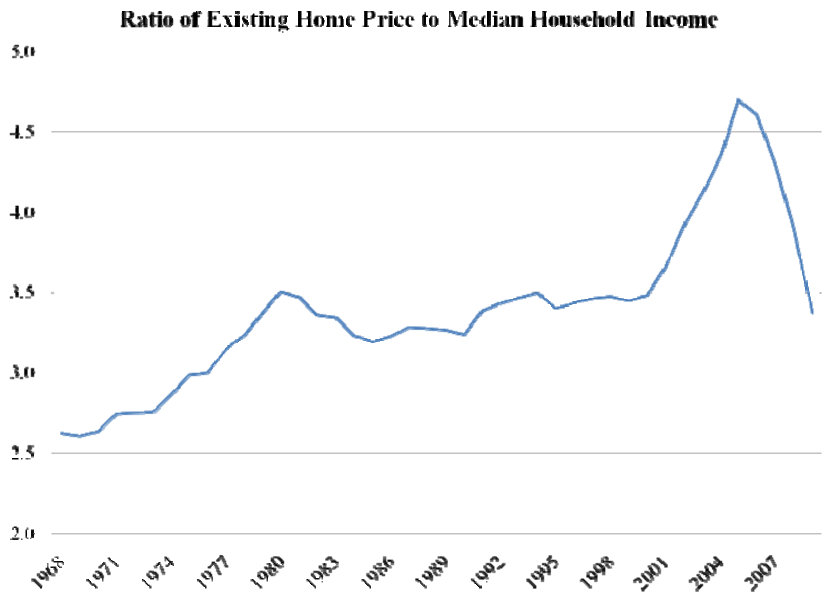
Figure 1



Sources: Federal Reserve, First American Corelogic

In Figure 2, we see that home prices spiked relative to incomes. It appears that beginning in the late 1960s the rise of the GSEs helped make more expensive houses more affordable, and then from the mid-1970s onward the new normal for the next 25 years was for home prices to average about 3.25 times annual income. Then beginning in 2001 the market took off and home prices peaked at 4.5 times annual income in 2006. How could this be sustained? Through affordability products.

Figure 2



Sources: Bureau of the Census, National Association of Realtors

Affordability products are mortgages that relaxed or ignored prudent underwriting guidelines to enable borrowers to acquire ever more expensive houses. Standards were eased and the face of the mortgage market changed. Figure 3 shows the changes in underwriting standards through the peak of the bubble in 2006.

Figure 3

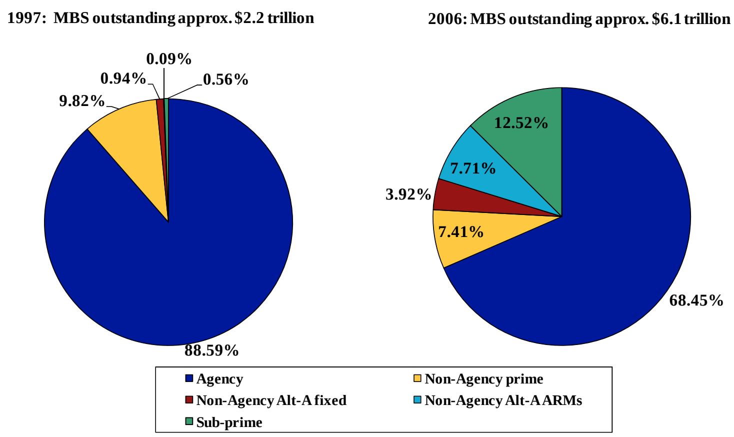
Sub-prime Collateral Attributes by Vintage Qtr

	Q1 2003	Q1 2004	Q1 2005	Q1 2006	Q4 2006
Orig Loan Size	145,763	160,842	173,076	187,833	189,337
FICO	613	622	621	627	632
DTI	40	40	40	42	42
Debt-to-Income >=45%	36%	36%	37%	44%	48%
Stated Income / Low Doc Loans	32%	36%	39%	45%	46%
Combined Loan-to-Value	80	83	84	86	89
Combined Loan-to-Value > 90%	3%	11%	19%	31%	38%
Orig LTV	80	81	81	81	82
Interest Only Loans	1%	5%	20%	24%	19%
Purchase Loan w/2nd lien for down payment	7%	29%	37%	53%	64%

Source: Credit Suisse

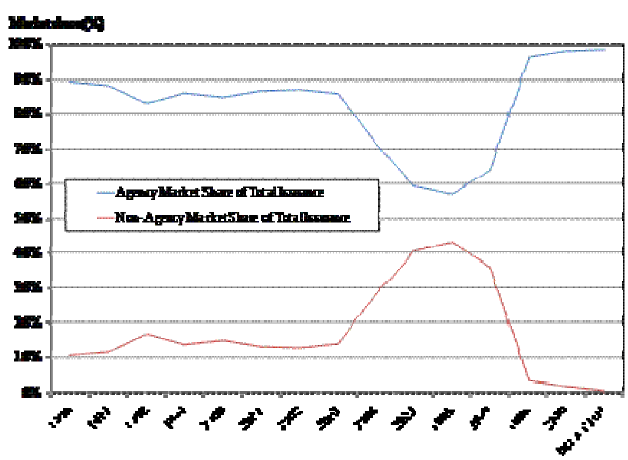
Figures 4 and 5 set forth the market share of Agency and non-Agency MBS outstanding and issuance. It is clear that the period of 2003 to 2007 was the anomaly.

Figure 4



Source: Deutsche Bank

Figure 5



Source: SIFMA

To us, this is the root cause of the financial crisis: A mortgage credit bubble built on poor, seemingly unregulated underwriting standards. Whatever the outcome of this process, avoiding this condition should be a component of housing policy.

To conclude, the market will adapt to whatever policy objective comes out of Washington, most likely by repricing the risk, uncertainty and friction of whatever replaces the current system. The consequences of change are that the size, scope, availability and efficiency of the current housing finance system will change as well. If the new system is significantly different than the housing finance system we have now, the consequences may be that our housing finance system is smaller, perhaps more appropriately priced, but with lower housing values and less flexibility and mobility for borrowers.

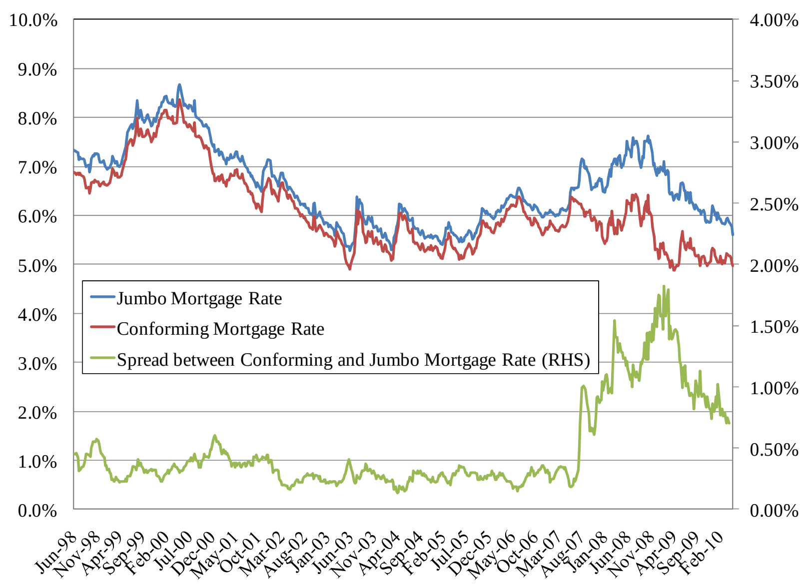
Answers to Questions:

1. ***How should federal housing finance objectives be prioritized in the context of the broader objectives of housing policy?***

The objectives as constituted in the original charter of the GSEs are a good starting point: to provide liquidity, stability and affordability to the US housing market, including stabilizing the nation's residential mortgage markets and expanding opportunities for both homeownership and affordable rental housing. In light of the experiences of the recent past, housing policy should also include as an objective minimizing the risk to the taxpayer of any government involvement.

To us, the single most important decision for policymakers is whether it should concern itself with setting standard and simplified underwriting practices for both rentals and homeownership. Everything flows from that decision, including arriving at the appropriate market-based mortgage rate and protecting the taxpayer. Figure 6 sets forth the differences between jumbo and conforming mortgage rates from 1998 to today, a period which included the period of arguably more prudent underwriting standards prior to 2003, as well as the bubble years that followed.

Figure 6



Sources: Bankrate.com, Bloomberg

Please note that during the credit crisis starting August 2007, jumbo rates (those that are not government wrapped) increased dramatically, partly reflecting the reduced liquidity and increased aversion to all credit-sensitive instruments. Importantly, the graph does not reflect the quantity of credit available at those rates. We believe that, while a mortgage market without some level of government support will have higher rates than one with government support, it can exist and capital will flow to it.. What is unclear is how much higher rates would be if there were no government-guaranteed portion at all and how large and efficient housing finance would be, especially in an environment where home prices are decreasing.

A commitment by the government to play a role in underwriting standards for the entire housing finance system and provide government backing to promote mortgage liquidity and availability leads to one set of potential solutions to a new housing finance market. If, as a matter of policy, the government wants to be completely out of the housing market, crafting the housing finance system will take a different path.

However, we believe that targeting or managing risk-based underwriting standards on the one hand and having zero government involvement in the mortgage and housing market on the other are irreconcilable policy objectives.

2. ***What role should the federal government play in supporting a stable, well-functioning housing finance system and what risks, if any, should the federal government bear in meeting its housing finance objectives?***

While we believe that the free market would find a way to set market clearing prices in order to establish a primary and secondary market for mortgage loans and MBS, we believe a housing finance system that utilized a government guarantee on securities would maintain the significant size and liquidity of the market, as well as provide for relatively lower costs to the borrower. The current housing finance system, certainly the one that prevailed up through 2003, is the most efficient credit delivery system the world has ever seen. It is like an electric power grid that delivers power to those parts of the country that have the demand, through efficient allocation of supply. But in the case of mortgage credit, the supply of credit comes from all corners of the globe, and the delivery is such that most borrowers of similar credit profile are able to access mortgage credit on essentially the same terms across the country. By relying on the grid, or in this case the secondary market, instead of the local bank, credit flows more freely.

There are several reasons why this works. First, securitization technology, where borrowers of similar credit are pooled and receive the benefits of scale in pricing. Two-thirds of all mortgages are held in securitized form, with only a portion of mortgages in raw loan form residing on bank balance sheets.

Second: the wrap, or the Agency guarantee to make timely payments of interest and principal. The wrap scales the process even further by making the securities more homogeneous, and takes conforming mortgages out of the universe of credit buyers and into the much deeper and more liquid market of rates investors. This is obviously a market that is much more willing to invest in times of market crisis. However, while the government guarantee will help to increase the size, scope and liquidity of the part of the market that enjoys that guarantee, prudent and risk-based underwriting standards should be maintained and enforced in order to protect the taxpayer from the risks of providing that guarantee.

Third, the to-be-announced, or TBA market, which is what Fannie/Freddie and Ginnie facilitate. The homogeneity and standardization engendered by the wrap mean that investors are evaluating the securities to see *when* not *whether* they will be repaid. This critical part of the market, by far the most liquid in the Agency market, is where the borrower meets the secondary market, and it enables originators and investors to hedge themselves. Where the rubber meets the road for Fannie and Freddie is the Agency cash window, or what they are willing to commit to paying an originator for forward production. Figure 7 is a screen shot of the Fannie Mae cash window commitment rates July 13, 2010. Originators can set their rates and offer up to 90-day rate locks to borrowers based on these rates.

Figure 7

Product Name: 30-Year Fixed Rate -- ***Favorite Name:*** *#2 30-Year Fixed Rate*

Amortization Type:	Fixed	Amortization Term:	30 Years/360 Months
Loan Type:	Conventional Loan	Loan Term:	30 Years/360 Months
Lien Type:	First Lien	Remittance Type:	Actual/Actual

EXPORT DATA FORMATTED VERSION (Requires Adobe Acrobat Reader)

PRICE NEW PRODUCT REFRESH PRICES

	10Day	30Day	60Day	90Day
Par Yield	3.9771	4.0011	4.0597	4.1304

Pass-Through	10 Day	30 Day	60 Day	90 Day
6.250	N/A	N/A	N/A	N/A
6.125	N/A	N/A	N/A	N/A
6.000	N/A	N/A	N/A	N/A
5.875	N/A	N/A	N/A	N/A
5.750	N/A	N/A	N/A	N/A
5.625	N/A	N/A	N/A	N/A
5.500	N/A	N/A	N/A	N/A
5.375	N/A	N/A	N/A	N/A
5.250	N/A	N/A	N/A	N/A
5.125	N/A	N/A	104.9722	104.6087
5.000	**104.8369**	**104.7080**	**104.4219**	**104.0509**
4.875	104.2900	104.1611	103.8716	103.4931
4.750	103.7431	103.6143	103.3213	102.9354
4.625	103.1783	103.0494	102.7530	102.3644
4.500	**102.5924**	**102.4635**	**102.1637**	**101.7781**
4.375	102.0064	101.8775	101.5743	101.1918
4.250	101.4205	101.2916	100.9849	100.6054
4.125	100.7950	100.6661	100.3544	99.9729
4.000	**100.1231**	**99.9943**	**99.6757**	**99.2862**
3.875	99.4513	99.3224	98.9970	98.5995
3.750	98.7794	98.6505	98.3182	97.9128
3.625	97.9566	97.8277	97.4917	97.0820
3.500	**96.9566**	**96.8277**	**96.4917**	**96.0820**
3.375	95.9566	95.8277	95.4917	95.0820
3.250	94.9566	94.8277	94.4917	94.0820

The cash window of Fannie Mae becomes a portal for the originator to meet the secondary market. Pull up BBTM on a Bloomberg screen to find what secondary market investors will pay for a Fannie 4% for forward delivery. Figure 8 sets forth the TBA market rates for July 14, 2010.

Figure 8

GRAB EquityFIT

Find Security 1) Markets 2) Workflow 3) Setup 4) Strategy TB30

FIT > TBA 15:59

		4.0	4.5	5.0	5.5
FNCL	Aug	101-12 / 13	103-21+ / 22+	105-27 / 28	107-15+ / 16+
	Sep	100-31+ / 00+	103-09+ / 10+	105-16 / 17	107-06+ / 07+
	Oct	100-20 / 21	102-30+ / 31+	105-05+ / 06+	106-30 / 31
	Aug/Sep	12¼ / 12+	12⅛ / 12⅜	11¼ / 11+	09⅝ / 09⅞
	Sep/Oct	11 / 11¼	11 / 11¼	09⅞ / 10⅛	07¾ / 08⅜
FGLMC	Aug	101-09+ / 10+	103-19+ / 20+	105-26 / 27	107-13 / 14
	Sep	100-29 / 30	103-07+ / 08+	105-13+ / 14+	107-03 / 04
	Oct	100-17+ / 19	102-28 / 29	105-02+ / 03+	106-26 / 27
	Aug/Sep	12¼ / 12+	12¼ / 12+	11⅞ / 12⅛	10⅛ / 10+
	Sep/Oct	10¾ / 11¾	10¾ / 12	11 / 11+	08 / 09
GNSF	Aug	101-26+ / 27+	104-10 / 11	106-22+ / 23+	108-08 / 09
	Sep	101-14 / 15+	103-30 / 31	106-10+ / 11+	107-30 / 31
	Oct	/	103-09+ / 26+	106-02 / 04+	107-21 / 24+
	Aug/Sep	11¾ / 12¼	11¾ / 12+	11⅞ / 12⅛	10¼ / 11¼
	Sep/Oct	/	05 / 20	07 / 08	/

Benchmarks

Treas 2Y	100-01 / 01¼	0.609 / 605	+ 03¾	Treas 7Y	100-02¾ / 03¼	2.486 / 484	+ 16¾
Treas 3Y	99-29¼ / 29+	1.029 / 027	+ 07	Treas 10Y	103-25+ / 26¼	3.050 / 047	+ 20¾
Treas 5Y	100-09¼ / 09+	1.814 / 812	+ 12¾	Treas 30Y	105-26+ / 27+	4.037 / 035	+1-08+

TB30 TB15 FN30 FN15 GD30 GD15 GN30 GN15 SW30 SW15 BFLY Favorites

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Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2010 Bloomberg Finance L.P.
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Not only does this process allow lenders to plan their pipelines and price their products, it also allows smaller lenders to compete with larger ones knowing there is a buyer for their product. It allows secondary market investors to plan their buying programs and hedge themselves. Trillions of dollars of annual volume goes through the cash window to get funded by the secondary market, thanks to the Agency guarantee, securitization and the TBA market. This is a role worth keeping.

Is the guarantee necessary for housing finance in the US? No, it is not necessary, but the economics of the non-Agency mortgage market are considerably different, both primary and secondary, and those economics equate to higher primary mortgage rates for borrowers and, depending on risk appetite within the private market, a smaller mortgage securitization market overall and thus less homogeneity and fungibility of housing credit. Furthermore, the economics of the non-Agency market are often derived from or based on the Agency market's existence, so it is difficult to handicap what they would be in a world without a wrap.

For perspective on relative pricing of mortgages, today, the rate on a 30 year conforming mortgage and a 30-year jumbo prime mortgage is about 4.75% and 5.5%, respectively. The jumbo prime borrower will likely need to be a pristine credit with at least 20% in down payment in order to qualify for the loan. As we have seen above, that 4.75% conforming mortgage will likely get packaged into a Fannie or Freddie 4% or 4.5% MBS, and the originator of that loan will have its capital recycled in order to make a new loan.

That 5.5% jumbo mortgage, however, is a different story. It will likely remain on the bank's balance sheet or be sold to another bank, as currently there is virtually no market for non-Agency securitization. The math for non-Agency securitizations only works with primary rates that are higher than they are today, given today's primary jumbo prime rates, the ratings agencies' requirements for senior and subordinated attachment points, and the return requirements for investors to buy the senior and subordinated tranches.

3. ***Should the government approach differ across different segments of the market, and if so, how?***

We observe that conforming and non-conforming mortgages are currently treated differently in the American housing finance system. By establishing the conforming loan limit, the government's approach sets forth a competitive advantage for any mortgage below that limit. The sectors of the mortgage market that are supported by the government will always have a competitive advantage in terms of rate and availability, and the securities that contain those mortgages will be more liquid and easier to finance. The jumbo prime market is generally priced off the Agency market. While it is understandable to want to try and minimize the government's involvement in the mortgage market by setting a conforming loan limit at lower levels, it is conceivable that increasing the loan limits would not only increase the revenue to the government for the guarantee, but potentially improve its credit exposure.

Government involvement in the multi-family market is good public policy, as these loans would otherwise be difficult to securitize, leading to higher commercial mortgage rates and thus higher rental rates, all other things being equal. Further, this involvement could be targeted for affordable rental opportunities in deserving areas with the appropriate underwriting standards.

4. ***How should the current organization of the housing finance system be improved?***

We are believers in the government guarantee, but we are indifferent to how that is structured or what kind of entity offers it. However, it is imperative that there be no question that the guarantee is an explicit full faith and credit wrap by the federal government. While the denouement of Fannie Mae and Freddie Mac (conservatorship by the US government, funding of losses by the taxpayers) has turned public sentiment away from these institutions, the fact remains that as organizations they currently are performing all of their operations as an instrument of public policy. Their cash windows, securitization process and management of the TBA market enables the mortgage market to function smoothly. They have relationships with a vast network of lenders and secondary market investors. Their professional staffs understand and have demonstrated the ability to meet their charter objectives. Most importantly at this time, the misaligned incentives of the shareholder-owned company are gone from their corporate objective.

Thus, from a market perspective, the path of least disruption and smoothest transition is to change the housing finance system by keeping what works and getting rid of what doesn't. We believe that Fannie and Freddie should continue to operate in conservatorship with a goal of winding down their retained portfolios over a set period of time. At that point in time they would either be recapitalized as heavily regulated public utilities or nationalized and perhaps merged into one entity. This would enable them to continue to have their MBS guaranteed with a government wrap, enforce underwriting standards, and enable the flow of credit from the secondary mortgage market to the primary mortgage market for conforming borrowers through the TBA mechanism.

The one aspect of Fannie and Freddie's current business model that would have to be replaced would be their portfolio activities. That is, their mandate to provide support and stability in times of market crisis or illiquidity. The private market could step up to play that role in tandem with the Federal Reserve.

Funding is an integral part of the mortgage market. The majority of Agency MBS investors are leveraged. Banks, insurance companies, foreign financial institutions and many private investors use varying degrees of leverage, while the GSEs themselves and the Federal Reserve are infinitely levered. All of these investors fund themselves in different ways, but they are all financed by different segments of the credit market. Whether it is deposits, the repo markets, the debt markets, the Agency debt market or Treasury sales financing the Fed's portfolio, all of these investors are levered and this financing is available and priced where it is because of the wrap.

Rather than establish a procedure by which some instrumentality or agency of the US government set itself up as a potential investor in mortgage assets in times of market crisis or illiquidity (like Fannie or Freddie used to, or the Federal Reserve did with its $1.25 trillion buying program), we suggest setting up a funding mechanism that would enable the private market to step into that role. In other words, the government would not be an investor of last resort, rather it would play its more traditional role as a lender of last resort. This could take the form of a TALF-like program which comes into existence during proscribed market conditions, charges high enough margin and rates yet still enables private capital to earn a return.

5. ***How should the housing finance system support sound market practices?***

With its risk retention language, the Dodd-Frank bill goes some way to fixing the problem of lax underwriting standards. By requiring the underwriter/sponsor of a securitization to retain up to 5% of the principal balance, their “skin in the game” should help align their interests. Moreover, by exempting “qualified mortgages” from risk exemption, it incentivizes underwriters to adhere to underwriting and product features that indicate a lower risk of default (such as verification of assets and income, maximum debt-to-income ratios, required mortgage insurance and others). In a qualified mortgage, it is the borrower with skin in the game. Establishing an underwriting standard that determines the amount of credit risk that needs to be retained by the originator/issuer is perhaps a more effective way to establish the proper incentives for the underwriter. So if a lender wants to make a 125% LTV/low-doc loan, they should have to live with a lot more of the risk of that loan than if they originate a fully documented, 80% LTV loan to a prime credit. It is this latter bucket that makes up the vast majority of homeowners and borrowers in the US, and the ones who primarily benefit from the mechanisms that work well in the mortgage market: the benefits of liquidity and cost that come with the scale and homogeneity of the conforming mortgage and the important TBA market.

In addition, the recent spate of so-called “strategic defaults” suggests that borrowers are coming to believe that there is little consequence for walking away from the obligation to perform on their mortgage. We believe that a sound market practice would be to introduce policies that would reinforce the personal accountability inherent in taking on a mortgage, such as the recently announced plan by Fannie Mae that would lock out a borrower from the market for 7 years if there is evidence of “strategic default.”

6. ***What is the best way for the housing finance system to help ensure consumers are protected from unfair, abusive or deceptive practices?***

Naturally, education, clear disclosure and enforced penalties for unfair, abusive or deceptive practices will help protect consumers. But more to the point of the past and future of mortgage finance, many of the homeowners created during 2002-2007 were not financially qualified to own their own homes and should have been renting. Adhering to good underwriting standards should mean that people who aren’t financially qualified won’t get a mortgage.

7. ***Do housing finance systems in other countries offer insights that can help inform US reform choices?***

We have not conducted extensive research on the housing finance systems in other countries. While other systems (Canada, Denmark, Australia come to mind) may work well in their countries, we do not believe that they can be an appropriate model for the US due to the lack of scale and diversity of their markets.

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Appendix II: Truth in Testimony Disclosure Form

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name: Michael A.J. Farrell	**2. Organization or organizations you are representing:** Annaly Capital Management, Inc.
3. Business Address and telephone number: 1211 Avenue of the Americas, Suite 2902 New York, NY 10036 212.696.0100	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2006, related to the subject on which you have been invited to testify? ☐ Yes ☒ No	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2006, related to the subject on which you have been invited to testify?** ☐ Yes ☒ No
6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature:	

Please attach a copy of this form to your written testimony.

Appendix III: Michael A.J. Farrell Biography

Mr. Farrell is the Chairman, CEO and President of Annaly and FIDAC. Prior to founding Annaly and FIDAC, Mr. Farrell was a Managing Director for Wertheim Schroder and Co., Inc. in the Fixed Income Department, served on the Executive Committee of the Public Securities Association Primary Dealers Division and as former Chairman of the Primary Dealers Operations Committee and its Mortgage Backed Securities Division.

Currently, in addition to his responsibilities at Annaly and FIDAC, Mr. Farrell serves on the Board of Governors of the National Association of Real Estate Investment Trusts (NAREIT), as a director of the U.S. Dollar Floating Rate Fund, a trustee of the Oratory Preparatory School in Summit, NJ and on the Board of Visitors of the Wayne Calloway School of Business and Accountancy, Wake Forest University.