

**Testimony of
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**Before the
U.S. House of Representatives
Insurance, Housing and Community Opportunity Subcommittee
of the Committee on Financial Services
Hearing on
“Are There Government Barriers to the Housing Market Recovery?”
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Good afternoon, Chairwoman Biggert, Ranking Member Gutierrez, and Members of the Committee. My name is Michael Farrell, and I run Annaly Capital Management, the largest residential mortgage Real Estate Investment Trust (or REIT) on the New York Stock Exchange. I also oversee the management of Chimera Investment Corporation, the second largest mortgage REIT. Annaly and our subsidiaries and affiliates together own or manage about \$100 billion of primarily Agency and non-Agency residential mortgage-backed securities (or MBS).

I represent an important constituency in the housing market, the secondary mortgage market investors who provide the majority of the capital to finance America's homeowners. Just for the Annaly family of companies, we estimate that through our MBS holdings our shareholders collectively help finance the homes of almost one million American households.

I'd like to begin by focusing on the fact that secondary mortgage market investors provide 75% of the capital to the US housing market. That is, of the approximately \$10 trillion in outstanding home mortgage debt in the US, about \$7.5 trillion is funded by investors in MBS. Of that \$7.5 trillion, about \$5.5 trillion is held by rate-sensitive investors in Agency MBS, with about \$2 trillion in credit-sensitive private-label MBS. The balance, or about \$2.5 trillion, is held in raw loan form, primarily on bank balance sheets. Since our country's banks have about \$12 trillion in total assets, there is not enough money in the banking system to fund our nation's housing stock, at least not at current levels. It is thus axiomatic that without a healthy securitization market our housing finance system would have to undergo a radical transformation.

Right now, securitization is attracting significant amounts of private capital, at least to the part of the MBS market that is government wrapped. This is to be expected, as this market always gains market share in counter-cyclical fashion. The problem is that the credit-sensitive, non-Agency sector of the market, or the so-called private-label market, is dormant, with only one small deal done in the last 2 ½ years.

I will now discuss several reasons why the private-label market is not restarting.

First, the economics don't work. In order for the math to work, either primary mortgage rates have to rise, the rating agencies' senior/subordinate splits have to come down, and/or return requirements by the secondary market have to decline. And yes, for good or for ill, the private-label market is still critically dependent on the rating agencies as the arbiter of credit quality.

Second, there is a higher yielding alternative for investors who want to take residential mortgage credit risk—legacy private label MBS and seasoned loans that have been repriced by the market after the events of the last few years. The return to investors from re-securitizing legacy MBS is higher than securitizing new mortgage loans. As long as this relative value disparity exists, it will impede the restart of the new-issue private-label market.

The third reason is the difficulty in sourcing enough newly-originated loans. Without the outlet to sell mortgages into securitizations, banks have gotten more comfortable holding non-conforming loans on their balance sheets, but only by tightening underwriting standards, including requiring sizable down-

payments. As long as underwriting standards are so stringent, I don't see a vibrant private-label market developing.

The fourth reason is the uncertainty over the future regulatory environment. The many different mortgage modification programs and delays in foreclosures have made it difficult for investors to analyze cash flows. The uncertainty over the capital rules related to the definition of "Qualified Residential Mortgages" and risk retention and Basel III is also putting a chill on the lending markets and concentrating origination in only the few largest banks.

Will lowering the conforming loan limit, reducing FHA's reach or raising guarantee fees help re-start the private label market? That is unclear. These efforts are a step in the right direction toward giving lenders more options and reducing the government's footprint, but they don't necessarily address the issues I have discussed. Those no-longer conforming borrowers could face much tighter underwriting standards, and higher guarantee fees for conforming mortgages will likely just show up in non-conforming mortgage spreads.

Finally, I want to get to the heart of the current debate: Can the private label MBS market come back to fill the credit gap that is currently filled by the GSEs? The short answer is: Yes it can, but not at the same price and not in the same size. Most investors in Agency MBS won't invest in private label MBS at any price or only in much reduced amounts, because their investment guidelines preclude taking credit risk. These investors include money market funds, mutual funds, banks, foreign investors, and governmental agencies. Some rates investors could cross over, but we won't know how many or at what price until we know a lot more about a lot of things. But at the end of the day I have to refer back to my two market truths: Securitization is the source of 75% of the capital to the housing market, and the private label securitization market isn't working right now.

I welcome any questions you may have.

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Biography of Michael A.J. Farrell

Mr. Farrell is the Chairman, CEO and President of Annaly Capital Management, Inc. (NYSE: NLY). Annaly is the largest mortgage REIT listed on the New York Stock Exchange, with a market capitalization of \$13 billion. Annaly and its subsidiaries and affiliates own or manage approximately \$100 billion in assets, primarily residential and commercial mortgages and mortgage-backed securities. Prior to founding Annaly, 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, Mr. Farrell serves on the Executive Board 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.

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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 	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2000 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, 2000 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. Attach additional grants or contracts on additional sheets. 	
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