M E M O R A N D U M

To: Members of the Committee on Financial Services

From: FSC Majority Committee Staff

Date: April 19, 2013

Subject: April 24, 2013, Full Committee Hearing on "Building a Sustainable Housing Finance System: Examining Regulatory Impediments to Private Investment Capital"

The Committee on Financial Services will hold a hearing on "Building a Sustainable Housing Finance System: Examining Regulatory Impediments to Private Investment Capital" at 10 a.m. on Wednesday April 24, 2013, in Room 2128 of the Rayburn House Office Building. This will be a one-panel hearing with the following witnesses:

- Chris J. Katopis, Executive Director, Association of Mortgage Investors
- Martin S. Hughes, President and Chief Executive Officer, Redwood Trust, Inc.
- James Millstein, Chairman and Chief Executive Officer, Millstein & Co.

Background

Before the financial crisis, the securitization of residential mortgages in the U.S. system of housing finance was split between the Government Sponsored Enterprises (GSEs)—Fannie Mae and Freddie Mac—and private securitizers. In theory, Fannie and Freddie were supposed to compete for a share of the housing finance market, which would increase the supply of mortgage credit and lower its cost for consumers. In practice, the GSEs used their government charters and the government guarantee those charters implied to dominate the mortgage finance market.

Notwithstanding the competitive advantages conferred upon the GSEs by their charters, the GSEs' charters prohibited them from purchasing and securitizing certain mortgages. Private issuers of mortgage-backed securities (MBS) purchased and securitized the mortgages that the GSEs were prohibited from purchasing. As a result, the private-label MBS market thrived as private sector investors sought out new opportunities to gain a return on their capital without relying on government-backed loans. Between 2002 and 2007, private issuers sold more than $3 trillion in MBS.

But in 2008, with the onset of the financial crisis, the private securitization market came to an abrupt halt. Holders of many private-label MBS suffered severe losses as defaults rose and the value of the homes that served as collateral for the underlying mortgages fell. New private-label MBS issues fell dramatically—to only $5.4 billion in 2010.

The downturn in the housing market that crippled the private MBS market also proved ruinous for Fannie and Freddie, which had invested in MBS. By September 2008, it was clear that both Fannie and Freddie were insolvent. The government stepped in to place both firms under conservatorship, using the financial backing of taxpayers and an explicit government guarantee to preserve and restore the value of each GSE's assets.

Conservatorship has allowed the GSEs not only to continue their mortgage market operations but also to greatly expand their market footprint and effectively drive their private sector competition out of the market. Fannie and Freddie have made use of their cost-of-funds advantage and explicit government guarantee to issue government-backed MBS at prices and credit risk levels against which issuers of private MBS cannot compete. As a result, investors have nearly completely abandoned the private label MBS market—the government is responsible for nearly 100 percent of the securitization market, with approximately 75 percent performed by the GSEs in conservatorship and roughly 25 percent performed by Ginnie Mae, which securitizes mortgages insured by the Federal Housing Administration (FHA). In fact, the displacement of private sector competition is so large that roughly 90 percent of all residential mortgage originations are securitized into government-backed MBS.

Beyond the market domination of the GSEs, there have been a number of regulatory changes that have created impediments to the deployment of private investment capital in the housing finance sector. Several provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) will likely affect the mechanics of asset markets. For instance, Title IX imposes new requirements on mortgage securitizers, including a requirement that securitizers retain some of the risk of the securities that they issue. Title IX exempts from this risk-retention requirement mortgage-backed securities that consist of "qualified residential mortgages," but federal regulators have not finalized the definition of "qualified residential mortgages." In addition, regulators have proposed requiring securitizers to establish "premium capture cash reserve accounts," which could drive securitizers out of the secondary mortgage market. Such accounts must be maintained for the life of the security, with the funds in the account occupying the first loss position on top of the 5 percent risk retention requirement. As a result, securitizers might not collect a profit until the security matures, which could be as long as ten years.

The Dodd-Frank Act is not the only source of regulatory change that will affect the securitization of mortgages. The most recent iteration of the Basel Accords will change the risk weighting for mortgages and MBS, which will affect the amount of capital that financial institutions most hold against these kinds of assets. The Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission have also issued many rules that affect the issuance, disclosure, trading, and investment in mortgage-related financial instruments. For example, SEC rules for disclosures relating to asset-backed securities (ABS) may affect the ability of private issuers to build a "Too Be Announced" (TBA) market similar to the one that exists for the GSEs. As explained in a staff report by the Federal Reserve Bank of New York, the TBA market is a 'forward' market where "the seller of MBS agrees to a sale price, but does not specify which particular securities will be delivered to the buyer on settlement day."[1] This delay allows borrowers to lock in interest rates as much as 90 days ahead of fulfillment, which can enhance liquidity in the MBS market.

This hearing will examine the effect that these and other regulatory changes have had on the deployment of private investment capital in the housing finance sector and the secondary mortgage market.

[1] James Vickery and Joshua Wright, "TBA Trading and Liquidity in the Agency MBS Market," August 2010, available at: http://www.newyorkfed.org/research/staff_reports/sr468.html