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http://www.sfindustry.org/

Chairman Duffy, Ranking Member Cleaver and members of the Subcommittee, thank you for the opportunity to testify today. My name is Daniel Goodwin and I am the Director of Mortgage Policy for the Structured Finance Industry Group, Inc. ("SFIG"), a trade association that represents over 350 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 housing finance reform, including finding an appropriate balance of private and public funding in the housing finance system. While the overall economic environment, and housing finance in particular, has recovered substantially since the crisis nearly 10 years ago and home prices in most markets have largely recovered, private capital's role in that recovery has been comparatively small, in historical terms, in relation to the government's role. The disproportionately large role of the government in today's housing finance system is the outcome of many factors but it is inarguably in an unhealthy condition. We believe this condition can be remedied, but reforms should be done in a manner which provides for a smooth transition that minimizes market volatility and maintains access to credit.

SFIG believes that the reform process must proceed in a measured and deliberate way. We appreciate the Committee's methodical approach in considering reforms that are inherently critical

to the U.S. housing market and the economy as a whole. In this process, we suggest one guiding principle: in order to provide consumers access to credit at competitive rates, there must be a stable, liquid, and efficient secondary mortgage market that allows responsible lenders the ability to compare funding costs easily across competing funding sources and readily access those same funding sources on a level playing field. Historically, these funding sources have fallen under two broad categories: publically supported funding and privately supported funding. Currently, approximately 70% of all new first-lien originations are backed by the taxpayer in some form, either through Fannie Mae and Freddie Mac (GSEs) or FHA/VA/USDA.[1] The remaining 30% comes from private funding, the vast majority of which is comprised of portfolio funding, with less than 1% coming from private-label securitization.[2]

Any considerations of housing reform should encourage a healthy and sustainable mix of publically-supported and privately-supported funding sources, eliminate hidden or implied guarantees or subsidies which might distort costs, and minimize risk to the taxpayer and the economy. While we strongly encourage steps to restore the private label securitization market because it removes risk from taxpayers, diversifies economic risk, encourages economic innovation, and ultimately reduces borrowing costs, we also believe that the continued presence of publically-supported funding is essential to provide counter-cyclical stability, act as a source of 30 year fixed mortgage credit to the consumer, and support the To-Be-Announced (TBA) market and support affordable housing goals.

[1] https://www.urban.org/sites/default/files/publication/93516/sep_chartbook_final_1.pdf
[2] Ibid.

In Support of a Government Guaranty

1. The TBA Market

The distinguishing traits of the TBA Market are the government guaranty and the homogeneity of the offered securities (i.e., standardized underwriting criteria and loan features, 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, principal balance, and trade 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.

The elimination of credit risk and homogeneity have created the TBA market, with trading approaching $200bn per day, which is deeper and more liquid than all other markets except the US Treasury market.[3] It is relied on as a tool by institutional investors to hedge interest rate risk or express a view on rate movements. 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 fixed income investors — insurance companies, foreign central banks, mutual funds and hedge funds — inject more capital into the market for financing mortgages and ultimately reduce the cost of credit to consumers.

[3] https://www.finra.org/sites/default/files/Analysis_of_Securitized_Asset_Liquidity.pdf

The TBA Market also provides a more direct and noticeable benefit to the housing markets, it 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. 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. The TBA Market creates efficiencies and cost savings for lenders that are passed on to borrowers in the form of lower rates.

Moreover, 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 each of 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. These costs would be directly passed on to consumers in the form of higher prices. 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."[4]

[4] https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr468.pdf

Furthermore, as the GSEs move ahead with the roll-out of the Common Securitization Platform (CSP) and the Uniform Mortgage Backed Security (UMBS) particular care and consideration should be paid to facilitate the standardization of MBS instruments that receive an ultimate government guarantee in order to ensure the continued functioning of the TBA 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 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.

2. 30-year Fixed Rate

I would like to speak briefly about the benefits of the 30-year fixed rate mortgage and its reliance on government support. Without the backing of the Federal government, it is unlikely that the 30-year fixed-rate mortgage, which remains an essential financing tool for homebuyers, could exist in the U.S. mortgage market. The fixed interest rate provides certainty, allowing a family to budget their housing costs and make long-term financial plans. The 30-year fixed rate mortgage has enabled borrowers to purchase and refinance homes with level and predictable monthly payments, and without fear of future interest rate swings. While homebuyers could theoretically attempt to price in the risk of future interest rate increases, the informational asymmetry and lack

of technical expertise would create inefficiencies that do not exist in the current market. These inefficiencies translate into increased borrowing costs for the consumer, limiting affordability, and introducing significant potential volatility into household budgets.

3. Counter-cyclicality and Providing Credit through Market Downturns

SFIG believes that an additional benefit of the government's continued presence in the mortgage market is that it acts as a counter-cyclical support, maintaining a presence through all market cycles so that in times of reduced access or tighter credit, credit-worthy borrowers can still obtain a mortgage at competitive rates. This was certainly the case in 2008 and 2009, when the private funding sources dried up entirely. Counter-cyclical support also benefits secondary market participants by acting as a market stabilizer, providing funding until such a time as private capital is willing and able to take on an increased level of mortgage credit risk. SFIG notes, however, that care should be taken so that public funding that has stepped up in the absence of private capital during a market downturn does not inadvertently work to crowd out private capital as the market recovers – a situation many industry observers believe is the case right now.

4. Affordable Housing

SFIG also recognizes that a housing finance system that relies on public funding sources has an obligation to serve the public, including Federally-backed affordable or subsidized housing policy goals or outcomes. 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. Implicit and opaque subsidies can distort markets, may

result in the benefits of certain programs accruing to borrowers who are not the intended beneficiaries, and can ultimately shift risk back to the taxpayer.

The Role of Private Capital

1. GSE CRT Program

At the outset of my testimony I stressed the importance of the appropriate mix of public and private support for the housing finance system. Over the past decade, publically-supported funding has played an outsized role in supporting the market, which has diminished the role of the mortgage credit investor and the private capital provided by such investors. While private capital has entered the market in the form of portfolio lending, this channel represents a smaller pool of capital than the fixed income markets, and serves to concentrate mortgage credit risk on the balance sheets of a few lenders rather than distribute it throughout a broad base of investors. Clearly much work remains to be done to restore a more healthy balance to these funding sources.

One area where there has been notable success in the reintroduction of private capital into the risk taking spectrum is via the GSEs CRT programs. SFIG applauds the work done by the GSEs to offload risk on 90% of its newly guaranteed mortgage production.[5] This program has clearly demonstrated that there is private capital eager to invest in newly originated mortgage credit risk, so long as investors feel their interests are protected and there is a reasonable amount of regulatory and legal certainty. We believe that the GSEs should build on their success expand their programs to include an even greater percentage of their portfolios and explore selling even

[5] https://www.fhfa.gov/aboutus/reports/reportdocuments/crt-overview-8-21-2015.pdf

more of the existing risk they retain on the CRTs to further reduce risk to the taxpayer. For instance, the GSEs sell only the riskier portions of the credit exposure in their CRT deals. While a market for the more protected portion of CRT may not yet exist, and the GSE's priority must be the economic viability of selling such a portion, developing this market and further reducing the retained risk is in the taxpayers' interest. By retaining the safer and more protected portions of the CRT, it effectively reduces the opportunity to attract pools of capital that might otherwise invest in senior credit. Additionally, the success of the GSE's CRT programs may provide the basis for exploring CRT on other government backed securities, like those of Ginnie Mae.

The former PLS market offered these deep pools of capital to fixed income investors in the form of investment grade securities, increasing liquidity and ultimately helping lower consumer borrowing costs. SFIG believes that while GSEs CRT programs are and should remain a vital part of any government-guaranteed MBS issuance, it does not replace the need for a vibrant private label securities market.

2. Reviving the PLS market

As noted above, the PLS market once represented a far greater share of the mortgage funding ecosystem. Market excesses and bad actors across the mortgage market led to the collapse in housing that fed the Great Recession. In response to that crisis, legislation and regulations were put in place with the goal of preventing the kinds of excesses we witnessed a decade ago.

While these laws and regulations were intended to reduce risk and prevent the dynamics and behaviors that led to the crash they were, in some instances, overly broad or created uncertainty.

This contributes to the current reality wherein some historically credit-worthy borrowers are unable to access credit because investors are neither willing nor able to provide capital that had previously been invested in mortgage credit risk. The end result is that many of the people who were hurt by the housing collapse now find themselves unable to benefit from the ongoing housing recovery.

In response to the crisis, the Dodd-Frank Act and resulting regulatory reforms were imposed to provide greater protection and stability to the housing market and economy. Largely, these reforms did not touch the GSEs, resulting in capital shifting towards the publicly supported market and away from the private market, as a result of the burdensome rules that were placed on that market. As this committee is considering housing finance reform and ways to attract that private capital, policymakers should review those policies which may have created an uneven playing field or inadvertent biases.

One such area is capital relief for non-GSE issuers of CRT, i.e. banks. Currently, it is very difficult for depository institutions subject to regulatory capital rules entering into similar transactions to be able to recognize the benefits of having transferred risk to third-parties. In most circumstances the capital reserved against the risk associated with such a transaction is greater than the required capital to be set aside for the loans themselves. Industry observers generally agree that, consistent, with common-sense, the amount of capital required to protect against loss in the system should be decreased when risk is transferred.

Another area worthy of consideration is highlighted in the Treasury Report – A Financial System That Creates Economic Opportunities, dated June 2017. The Treasury states: “Prudential bank

regulators should review the regulatory framework for risk-weighting applicable to securitizations in order to better align the framework with the risk of the asset and with international standards for securitized products. Increased capital and liquidity standards have negatively impacted the economic attractiveness of PLS."[6]

A more straightforward way to encourage expansion of the PLS market is by lowering the conforming loan limits of Fannie Mae and Freddie Mac. Loan limits were raised to their current levels in an environment with a robust and competitive PLS market and where the GSEs were not in Conservatorship. Today, it is more difficult to support government subsidies that benefit borrowers with mortgages on properties that approach — and in many cases, exceed — half a million dollars or more. SFIG believes that a slow and measured lowering of loan limits could transfer risk from the GSEs and to investors through the PLS market. The narrow spread between current conforming rates and non-conforming jumbo rates suggests that private capital is able to take on 100% of the credit risk of these mortgages at competitive rates, with no need for the government effectively to subsidize and take on the risk of these mortgages.

The industry itself is working to revive the PLS market. SFIG and its members are actively engaged in RMBS 3.0, an initiative that uses lessons learned in the crisis to promote standardization of best practices and to reduce substantive differences within current market practices through an open discussion among a broad cross-section of market participants. We would be happy to share this work with members of the Committee.

[6] https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf

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 the potential opportunities to re-invigorate the PLS market, all in the service of facilitating a more robust, liquid, competitive, and stable housing market.

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.