Written Statement of Michael Canter, Ph.D.

Senior Vice President and Head of Securitized Assets, AllianceBernstein

On behalf of AllianceBernstein

Before the Subcommittee on Housing and Insurance

December 6, 2017

Chairman Duffy, Ranking Member Cleaver, and members of the Subcommittee, thank you for the opportunity to testify today. My name is Michael Canter and I am Senior Vice President and Head of Securitized Assets at AllianceBernstein (AB). AB is an asset management firm with $500 billion of assets under management – that we manage on behalf of pension funds, retail mutual funds, insurers, charities, individuals, and global investors. I am appearing here today on behalf of AB – one of the largest investors in the CRT market.[1] AB is a member of SIFMA (the Securities Industry and Financial Markets Association) and I am also on the board of the Association of Mortgage Investors.

Housing Finance Reforms – A CRT Investor's Perspective

The debate around Housing Reform has been heating up recently with numerous proposals being put forward by various interested stakeholders. I agree for the need to further housing finance reform viewing the status quo as untenable longer term. However, I view the process of Housing Finance reform as a continuum, noting that the Government Sponsored Enterprises (GSEs) that are at the center of the housing finance system and their regulator the Federal Housing Finance Agency (FHFA) have already made some progress in reforms post-crisis most notably through the introduction of the Credit Risk Transfer (CRT) market. CRTs are debt issuances with payments linked to the credit performance of an underlying pool of loans, and they provide a layer of private capital as well as a source of market pricing of risk that the GSEs had lacked pre-crisis. As we move forward with reforms, I think it's important to build on these early successes especially since it's clear that we need to promote even greater involvement of private capital in housing finance, making future tax payer risk even more remote.

In this testimony, I lay out what I believe have been the drivers of the CRT market's success. Preserving and enhancing these drivers will be most likely to help the success of housing finance reforms in the years ahead, and to help prevent a repeat of the housing crisis of 2008.

But before I delve into my views on the future, a quick recap of where we stand and how we got here.

---

[1] This testimony is based on a paper co-authored with Janaki Rao of AB, "Housing Finance Reforms – A CRT Investor's Perspective."

The Past

Prior to the crisis the GSEs existed as private entities with public charters and implicit government backing. As private entities, the GSEs looked to maximize equity returns, which led them to invest in mortgages in whole loan and securitized form in a levered manner in addition to their core business of guaranteeing MBS. However, as the subsequent bail-out of the GSEs by the Government in 2008 showed, this model was unsustainable because it promoted risk taking which benefited private investors in ways that were not necessarily consistent with their public mission, with the implicit understanding that the tax-payers would bail-out the GSEs that were deemed "too-big-to-fail."

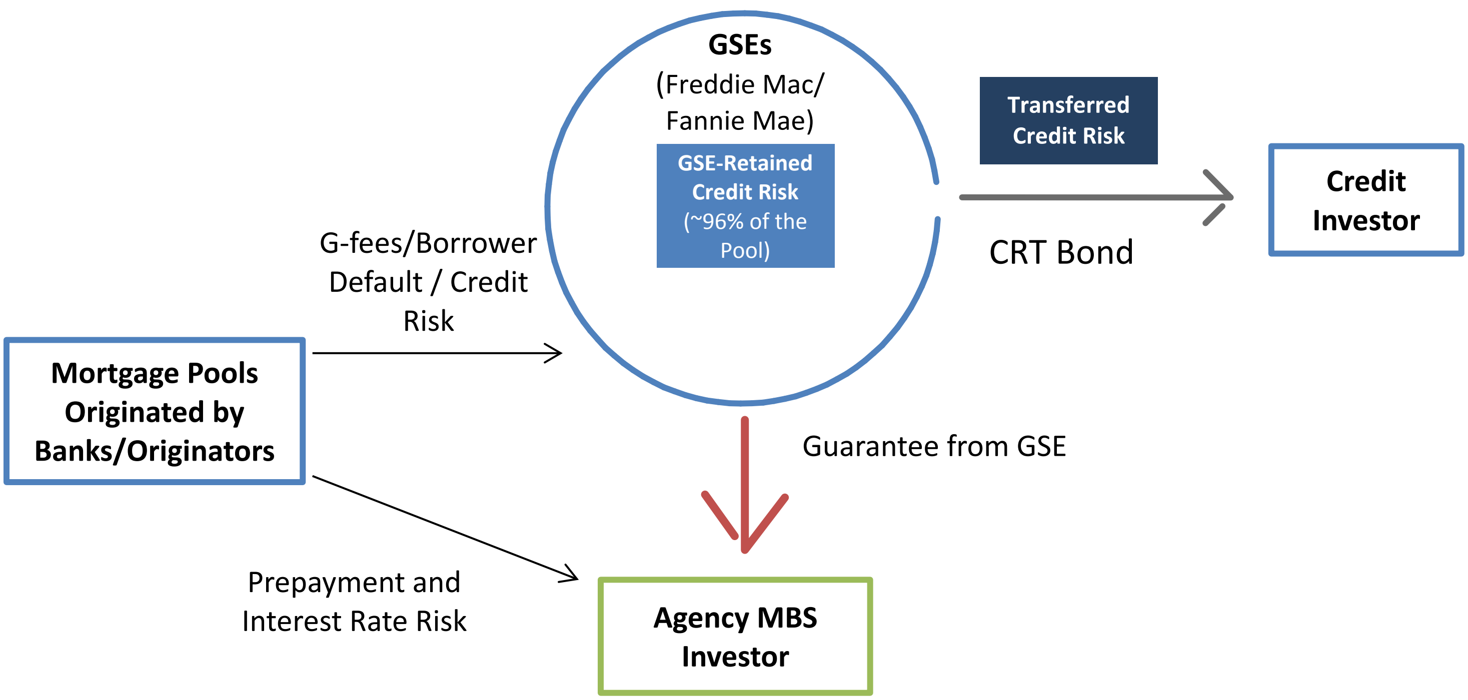
The Present

In 2008, the GSEs received a sizable equity inflow from the Treasury and today continue to have an agreement with the Treasury to inject further capital as required. This capital backstop is sizable but limited. In return, the GSEs are required to sweep all earnings to the Treasury over a minimal, declining capital buffer. In addition, the GSEs were placed in conservatorship under their revamped regulator, the FHFA. Under the terms of the conservatorship, the FHFA has a significant say in the running of the two GSEs including in product development that has limited their risk-taking ability. Furthermore, the terms of the Treasury agreement with the GSEs includes reducing the GSEs sizable retained portfolios. The regulatory environment also tightened as Congress and the Administration moved to avoid a repeat of that housing crisis. A combination of tighter regulation and lowered risk appetite means that the GSE guarantee books present a far more favorable credit profile at present.

Meanwhile, the GSEs as required by their regulator have started reducing their credit exposure further through various structures including the Credit Risk Transfer (CRT) securities. From a GSE and taxpayer perspective, the creation of the CRT market introduces a layer of private capital cushion that didn't exist before. The CRT issuances also provide a market-based source of price validation. For instance, CRT spreads reflect private investors view of the credit risk and can thus be compared to the Guarantee fee charged by the GSEs. For mortgage credit investors, the CRTs represent an investment opportunity that is especially valuable since the non-agency RMBS market is in decline with limited issuance post-crisis.

A graphical description of the current situation is depicted below.

Display 1



The status quo, however, is unlikely to be long lasting. The status of the GSEs is dependent on their Treasury equity back stop, which is limited. This limited support was by design to prevent the status quo from becoming permanent. While there remains significant runway before the Treasury's backing disappears, the discussion around the future state of the GSEs is gathering momentum. There is also recognition that housing finance reforms may unlock potential growth if it increases credit availability.

In the following section, I highlight factors that I believe led to the success of the CRT program. It is these successes on which future reform efforts should build.

What Made the CRT Succeed?

1. **Role of the FHFA:** The development of the CRT market was innovated by the GSEs, but highly encouraged by the FHFA as they mandated risk reduction at the GSEs while in conservatorship. Pre-crisis, however, the ability of the regulator to influence the GSEs was very limited. That changed in 2008, during the crisis, as the Government stepped in to bail-out the two GSEs. That year Congress passed the Housing and Economic Recovery Act (HERA) that established the FHFA as the GSEs regulator. The FHFA replaced the Office of Federal Housing Enterprise Oversight (OFHEO) and the Federal Housing Finance Board (FHFB) – the erstwhile regulators of the GSEs

and the FHLBs respectively. HERA also transferred mission supervision of the GSEs from the HUD. Importantly, the Act provided the FHFA supervisory authority on par with other federal safety and soundness supervisors. These changes allowed the FHFA to relentlessly focus on getting the GSEs to reduce their risk by involving private capital.

Looking to the future, a healthy housing finance market requires an appropriate regulatory and capital regime that emphasizes continuing risk transfer to private capital. Having a regulator that can continue to push the GSEs or their successors to continue down that path is therefore important in our view. The best way to formalize this credit risk transfer is through the capital plan that the regulator will need to craft going forward. The capital structure that the GSEs operated under pre-crisis was designed to maximize earnings by keeping the capital cushion thin thereby increasing the risk for tax-payers. The GSEs under the current conservatorship regime are not allowed to build any capital with all earnings swept to the Treasury. However, in a post-conservatorship world the regulator need not be overly prescriptive in a new housing finance system, but must create a well thought out capital framework that puts a high value on risk transfer and appropriately discourages risk taking above and beyond the risk retention needed for CRT issuance. The regulator must also be cognizant that GSEs/ guarantors can become focused on short term results and thus, a regulator should give attention to ensuring that the CRT structures are well conceived and durable so that they can support US housing for decades to come.

2. **Skin in the Game:** An alignment of interests re-assures investors beyond any risk metric alone. As structured today the GSEs only partly transfer their credit exposure – they retain first loss risk along with 5% of other tranches of the CRT structure, while retaining the most risk remote tranche (typically the most senior 96% of the structure). Therefore, the GSEs are sharing the same risk as the CRT investors. This stands in contrast to the "Originate-to-Distribute" model that existed in pre-crisis nonagency bonds whereby loans were securitized and sold to investors with originators not retaining any risk -- a significant contributing factor in the housing crisis. Therefore, the alignment of risk interests is an important factor in the success of the CRT program and should be retained in future iterations of Housing finance. There is an abundance of capital willing to take more first loss risk and more senior risk- should legislators, regulators, or the GSEs/Guarantors want to transfer it, but risk retention is essential.
3. **GSEs' Market Power:** The success of the CRT program had a lot to do with the ability of the GSEs to drive the changes needed to make it successful. This ability to enforce change has a lot to do with the dominant market power that they display. Their market power has conferred several benefits to the market:
    a. The GSEs' roles as deal agents, in a manner of speaking, where they orchestrate the whole process of securitization from origination onwards. In this role, the GSEs set origination, underwriting and servicing guidelines and importantly enforce the guidelines. For originators and servicers, the GSE securitization route represent a lucrative business opportunity, but in turn they must play by the rules that the GSEs lay

out. Clearly, the size of the GSEs is an important reason for their ability to be a successful deal agent;

b. The institutional knowledge and skills that the GSEs have accumulated over the decades that they have been in business of guaranteeing mortgage credit risk is a considerable competitive advantage. The experience of the recent housing crash has added to the depth and richness of the GSE knowledge in a way that would have been impossible to do so without;
c. The infrastructure the GSEs have built over the years to make the MBS securitization business successful is critical to their market acceptance and a model for the rest of the market (e.g., loan documentation, etc.).

4. **More than 1 GSE:** Having more than 1 issuer of CRT has been beneficial. Fannie and Freddie have competed amongst themselves to offer their investors products that best meet their expectations. In the process the GSEs have experimented and have benefited from having a competitor's product act as a "control product" thus helping isolate what works and what doesn't. In addition, the GSEs have also divided the task of designing a better product between themselves and thus achieving greater efficiencies along the way.
5. **Liquidity/Transparency:** The CRT market's development has also been aided by the enhanced liquidity and transparency in the CRT market relative to private label RMBS. This is a combination of various factors, as I describe below:
   a. **Historical data and experience:** A critical piece of the CRT market's success in our view is the availability of twenty years of loan level performance data; including the crisis, which defines the worst-case scenario for a mortgage credit investor. Some of the experiences through the crisis, for instance extended resolution timelines for defaulted mortgages, would have been impossible to predict pre-crisis. In addition, there is the knowledge gained of what works and what doesn't, meaning that there is clarity around the integrity of processes going forward leading to more reasonable expectations built into scenarios. But, to be fair, the data has been significantly influenced by government intervention at all levels, including the mandated modification programs that were implemented. Should another crisis occur and different policies be in effect, the historical data may not prove as effective a guide as previously thought.
   b. **TRACE:** FINRA's TRACE dissemination of trade prices for CRT transactions has led to more efficient price discovery as trade prices are disseminated widely and on time. This is an important development that removes a significant flaw of the previous non-agency market where price discovery was cloudy at best.
   c. **Dealer involvement:** Dealers have been competing to provide liquidity in the CRT market. The banking fees from the primary issuance of the CRT securities are attractive and make the Dealers willing to participate in the secondary market despite the onerous capital charges that holding CRTs involve. Dealer interest in making markets in CRT is a recognition that the CRT market is here to stay and is growing – and could be much improved were capital requirements rationalized.
   d. **Issuance calendar:** Having a frequent schedule of issuance has helped maintain liquidity in the market. The GSEs have borrowed heavily from their experience in the Agency

Debt market in have a well-defined issuance calendar but also been helped along by the FHFA setting targets on their issuance. Frequent issuance also allowed the GSEs to experiment with various innovations that they could then compare against nearby issuance to see what works and what doesn't as they had reasonable data points to compare with.

e. **Large deals:** CRT deal issuance size have been large, and that has contributed to their liquidity. Some part of the large issuance size was due to the design of the program, where the GSEs have warehoused loans and issued CRTs over a schedule that allows for large issuance size. However, some of the larger issuance has also been due to the high origination volumes over the past few years that the CRT program has been in place. This however is not completely in the control of the GSEs and origination volumes have declined from their peaks and may remain depressed unless mortgage rates move lower. Nonetheless, the large deal size and frequent issuance mean that large investors have participated in the program as they could scale up their investments.

6. **Market Conditions:** Finally, I acknowledge the positive impact that market conditions have had on CRT's success.
    a. **Tighter Underwriting:** The pendulum of credit underwriting has swung towards greater conservatism in response to the housing crisis. This has kept credit performance high even relative to the pre-crisis period. Investors have benefitted from the positive performance, which was critical for the budding CRT market to establish itself.
    b. **Failure of Non-Agency MBS to Launch:** The non-agency RMBS market has not returned in any appreciable size post-crisis. In addition, with the legacy non-agency RMBS market declining as loans pay off, investors looking for housing credit exposure have little to no options outside of the CRT market. Indeed, there was a tremendous buildup of intellectual and technological capital in mortgage credit in the years following the distress in the mortgage market. As volatility subsided, this capital was primed to focus on a new mortgage product. This provided momentum in the initial phase of the CRT market without which it could easily have withered.
    c. **Risk-on:** The risk-on environment has also expanded investor appetite, which has been fortuitous for a new product like CRT to establish itself as part of the menu that investors look at.
    d. **Strong Economic Environment:** The strong economic environment since the launch of the CRT market has also been a positive influence. Modest but positive economic growth, strong home price appreciation, and low unemployment have contributed to positive performance besides the tighter underwriting I mentioned earlier.

Without taking anything away from the product design and the inherent qualities and appeal of the CRT product, there is no doubt that the product was fortuitous in its launch timing as well.

The Appeal of Back End CRT

In reviewing the many different GSE reform proposals being evaluated by Congress, it is clear that risk transfer plays a prominent role in almost all of them. The fact that the GSEs have multiple avenues to hedge their risk is important, and all have value, but I see the fixed income / bond market solution as the cornerstone to any system going forward, for a number or reasons:

1. All CRT bond issuances are fully funded - the GSEs do not have counterparty risk, and don't have to worry about risk unexpectedly coming back on to their balance sheet. There are some proposals that highlight the potential of greater use of mortgage insurance (sometimes called deep MI). It is important to consider that the ability and willingness of MI companies to pay claims becomes highly questionable in times of stress; it certainly did during the crisis. The GSEs already have $200bln of counterparty exposure to the MIs, and deep MI would only increase that.

2. CRT bonds can be distributed across a wide swath of investors and included in diversified portfolios all over the globe. So, should we enter a high default environment, the risk of loss would have a diminished impact because these portfolios only have a small portion of their portfolios/capital invested in these securities. In contrast, mortgage insurers' entire levered capital base of $12.5bln is exposed to mortgage losses. Following an adverse economic environment, the trillions of dollars that exist in the global fixed income markets are the deepest source of capital that can price and take risk.

3. The capital markets provides cash to the GSEs at the time the risk is sold, and writedowns are immediate, whereas recouping MI payments can be a long drawn out process involving negotiation and sometimes litigation.

Envisioning the Future

I have examined various proposals on the future of housing finance, which range from recapitalizing the GSEs and returning them to their pre-crisis state, a complete privatization of the GSEs with no Government linkages to an explicitly guaranteed GSE issued MBS. I find the idea of an explicitly guaranteed GSE issued MBS to be the most appealing for the reasons explained below:

1. **Maintain the TBA market.** In general, our approach has been to preserve elements of the system that work, and the To-Be-Announced or TBA market is a successful, critical part of the current housing finance system. The TBA market is a source of over $5 trillion in financing for the housing market from rate investors that is unlikely to be replicated using credit investors alone. The TBA market is also the source of pricing in the primary market and helps borrowers to "lock-in" rates during the home purchase/refinance process and lenders to hedge their pipeline.

2. **The 30-year Fixed Rate Product.** Without a Government guarantee, the fixed rate 30-year mortgage may no longer be available as credit investors will not be willing to shoulder the entire duration risk of a non-guaranteed 30-year, fixed rate mortgage product. The absence of the 30-year mortgage would be hugely disruptive to the housing market as it is the preferred choice of financing for home buyers, and its withdrawal would impact not just home transactions going forward but also home prices.

Maintaining the TBA market and the 30y fixed rate product will require Government support. I believe that support should be in the form of an explicit guarantee on the MBS issued by the GSEs or their successors. I understand the concerns of those who argue against having taxpayers on the hook for any future losses. However, I would counter that it is unlikely that any government, now or in the future, would do nothing if a housing crisis of the magnitude that hit in 2008 were to hit the US again. Thus, it is better to explicitly recognize reality and get paid a fair fee for the guarantee provided. In addition, I believe that the taxpayers should be protected by:

1. Requiring significant private capital before the Government's guarantee;
2. Charging an actuarially-based premium for issuing the guarantee;
3. Providing for robust regulatory oversight over the guarantors of the guaranteed MBS.

The Government should establish a separate mortgage insurance fund, like the FHA's Mutual Mortgage Insurance Fund. This would allow the Government to ensure that they are getting a fair price on their guarantee and be transparent.

In addition, I advocate for retaining the GSEs either under the existing charters or as re-chartered entities as guarantors under the reformed system. In addition, the FHFA (or successor regulator) should be granted authority to charter other guarantors if they feel that is necessary, although I think the bar to add more guarantors should be high. The newly chartered guarantors should continue with parts of their current role including operating a cash window execution to help smaller originators with managing their origination pipeline. In addition, the move towards a single security as well as the development of the common securitization platform should proceed and form a part of the reformed system.

Having laid out our vision of the future, I want to spend some time explaining why I think the structure laid out builds on the success of the current reform efforts that have led to the CRT.

Our View on Policy Choices Facing Legislators

As stated at the beginning, I believe that housing finance reform should build on the successes of the previous efforts at reform that have led to the CRT market. I present the following views as a CRT investor. This is an important perspective as private capital is expected to provide a capital cushion before the tax-payers. CRT investors are a part of the private capital cushion, and a critical one at that, as they are the only ones that are external to the origination process, i.e. outside of the borrower's equity and the Guarantors and can thus provide a market based pricing check. Based on the factors that

I described earlier as being instrumental in CRT's success, here are our views on some of the important elements of housing finance that are currently being debated.

1. **Common Securitization Platform:** The common securitization platform or CSP helps retain several elements of the above-mentioned factors. For instance, the CSP leverages off the institutional knowledge and skills built by the GSEs over the past few decades. In addition, the CSP takes over the role of the GSEs as the "deal agent". The CSP will act as a utility providing the infrastructure that will be used for future securitizations. I anticipate that the CSP will verify and validate the origination and securitization process and thus act as a deal agent on behalf of the Investor. This addresses concerns that investors had with the pre-crisis securitization model. Note that the CSP can accommodate both guaranteed and non-guaranteed mortgage issuance.

2. **Guarantors:** Again, I would encourage the utilization of the bits of the current system that have worked. The GSEs have a long experience with guaranteeing mortgage securities and that expertise should be saved. Whether the GSEs are kept in their current corporate shape or reincarnated as new entities – preserving the current expertise is important. Why this matters to us is that this expertise provides a level of comfort as the GSEs and CRT investors have aligned interests and the GSEs control the credit underwriting dials. There are additional questions that arise when I think about the guarantors as I discuss ahead.

    a. **Light Touch Private Entity or Highly Regulated Utility:** This addresses the question of how to balance innovation and stability. Lightly regulated private for-profit entities are well designed to innovate as they seek to maximize their earnings. These innovations could be both on the origination side of the business as well on their issuance side; for instance, as credit investors we are interested in the different structures that could be used to lay off risk. However, I also recognize that innovation potentially leads to greater instability, which in turn increases the risk of equity cushions being reduced. Note that this issue is also related to the following one that looks at the type of investors. In our view, the desire for stability and avoidance of future government interventions would lead to a more regulated utility model with a guaranteed rate of return. This would reduce the incentive to innovate but lead to a more stable outcome, thus placating concerns on the side of those who would prefer that tax payers have no exposure to future housing market losses.

    b. **Outside Investors or Mutual:** Another issue to be addressed is whether the guarantors are capitalized using outside investors or through a mutual structure whereby they are capitalized by the originators that utilize their guarantee. I believe that a mutual structure is better suited to the mortgage guarantee business as it allows for a dedicated investor base that will likely to recapitalize faster in the event of a crisis unlike outside investors that may hesitate to do so. I also believe that the mutual structure creates a better alignment of interest between the originators and the guarantor. This alignment should create better outcomes both at the front and back end – meaning that originators are better incentivized to adhere to underwriting standards set by the guarantor as well as making put back decisions less contentious. This structure could prove beneficial to borrowers and the housing market if the lowered risk of contentious put backs causes originators to shrink the credit overlays.

c. **National vs Regional Guarantors:** Should guarantors be national or regional in scope? Regional guarantors can build their policies to better reflect their regional housing markets. However, regional guarantors would lack diversity in their credit portfolios and thus exposed to a regional housing downturn, which have tended to be more common than national housing downturns. A regional guarantor would also have low competitive pressures unlike a national market as it's inconceivable that there could be more than 1 guarantor in most regions. As CRT investors, we prefer a product that is scalable and thus a national guarantor model would be our preferred choice. A nationwide market would thus be able to create a more liquid product with a regular issuance calendar.

3. **Easing Regulatory Burdens:** It has been suggested that origination volumes could be higher with a few regulatory tweaks. Mortgage originators, bank originators in particular, have been vocal about the impact that various regulatory burdens are placing on their ability and/or willingness to originate loans. The GSEs have made some changes to their origination process to make the representation and warranty risk less onerous and more upfront to prevent large scale put back risks later in the cycle. This has helped ease the credit box to some extent and further easing of regulatory pressure could build on that. I welcome tweaking of the regulatory environment to the extent that it allows for an easing of burdens on the originators and expands the origination universe. An expanded origination universe is a positive from the broader perspective of economic growth but also specifically it helps maintain the liquidity and scalability of the CRT product. However, while I am against any wholesale easing of credit standards, I feel moderate changes will be a positive provided our other suggestions are accepted, meaning that the CSP acts as a "deal agent" and the GSEs continue to have "skin in the game" through warehousing and risk sharing.

Improvements That Can Be Made Today

While I have many subtle structural suggestions, the two bigger picture issues that I would like to bring to your attention are:

- The Broker/Dealer Capital charge for holding/trading these securities is unnecessarily onerous at 100% or greater. This is detached from the reality of the risk in these bonds and does nothing to help support the housing market.
- The GSEs should give serious consideration to separating out the natural catastrophe risk embedded in CRTs.

If homeowners default on their mortgage because of a flood, hurricane, or earthquake any resulting loss flows through to the CRT structure as currently constructed. This may be good for the taxpayer in the short term, but not the longer term. I believe these risks have been woefully under-modeled and under-considered by the GSEs, rating agencies, and most investors. Simply put, CRT investors are experts in evaluating mortgage credit risk, not natural catastrophe risk. I am concerned that should there be disasters that affect the value of investors' CRT holdings it could have a permanent damaging effect on the market. If the goal is to create a market that is durable for decades to come, the GSEs need to hire firms with expertise in natural catastrophe modeling to better understand the risks. If this analysis is then shared with the market, it can more fully understand and price the risks being transferred. At that point the GSEs can evaluate keeping the CRT structure as is or separating it from natural catastrophe risk. They could achieve this by buying separate natural catastrophe protection in the reinsurance market where that pricing expertise lies. As we have seen in the private label nonagency market, once a market has structural flaws, and losses result, it is often too late to create a better structure. We await analysis from the GSEs in this regard, but without that information I would support the separation of true mortgage credit risk from natural catastrophe risk, as I think this would best serve the longevity of this extremely important source of risk capital for the U.S. housing market.

In conclusion, I want to thank you all for proceeding with this critically important reform effort. We at AllianceBernstein and the investor community stand ready to assist you and your colleagues as you help develop a more sustainable housing finance system