



Written Testimony of Kevin G. Chavers

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on behalf of the

Securities Industry and Financial Markets Association

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Committee on Financial Services

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Perspectives on Housing Finance Reform”**

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Chairman Duffy, Ranking Member Cleaver and members of the Subcommittee, thank you for the opportunity to testify today on the important topic of housing finance reform. My name is Kevin G. Chavers, and I am a Managing Director at BlackRock focusing on public policy issues, testifying today both on behalf of BlackRock and the Securities Industry and Financial Markets Association (SIFMA)¹. BlackRock manages assets on behalf of individual and institutional clients across equity, fixed income, real assets, and other strategies. Our clients include pension plans, charities, foundations, endowments, official institutions, insurers and other financial institutions, as well as individual savers around the world. The assets we manage represent our clients' futures and the investment outcomes they seek, and it is our responsibility to help them better prepare themselves and their families to achieve their financial goals.

SIFMA and its member firms, BlackRock included, appreciate the attention being paid to housing finance reform and believe it is timely for Congress to move forward with meaningful reforms that protect taxpayers, ensure access to affordable housing, and maintain deep and liquid markets, including the preservation of a highly liquid To-Be-Announced Market (TBA).

Over the past nine years, there have been significant changes in the housing and securitization markets, as well as critical changes to Fannie Mae and Freddie Mac (collectively, the GSEs). These changes include:

- significant reductions in the size of the GSEs' portfolios,
- enhanced underwriting guidelines,
- increased guarantee fees,
- innovative structures for introducing private sector credit enhancement including a new Credit Risk Transfer (CRT) market,
- revised representation and warranty requirements,
- the ongoing implementation of a Common Securitization Platform and
- the development of a common form of mortgage-backed security that could be traded with a single TBA contract.

Further, the environment for the housing market and housing finance has changed dramatically during the post-Crisis period, and relative to the previous Congressional attempts at reform. Housing prices in most markets across the country have recovered, with some exceptions. The Consumer Financial Protection Bureau introduced new regulations that address both underwriting standards and mortgage servicing geared toward protecting borrowers. Rating agencies have significantly revised their ratings criteria and methodologies. In light of the current environment, this backdrop is more conducive to pursuing housing reform than at any time since the Crisis.

Since the financial crisis, policymakers have contemplated an array of proposals for what the next iteration of the housing finance system could look like. While SIFMA believes that some of these proposals are worthy of consideration in whole or in part, we would like to take this

¹ SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$20 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

opportunity to discuss the key principles SIFMA believes Congress should consider when developing any housing finance reform legislation. At a high level, our guiding principles for reforming housing finance are: (i) the need for a clearly defined and limited government role to facilitate liquidity, yet protect taxpayers, (ii) transparency at all levels, and (iii) a framework to attract private capital. A sustainable proposal needs to be comprehensive in considering the roles and structures of Fannie Mae, Freddie Mac, the Federal Housing Administration (FHA), and Ginnie Mae, as well as their regulatory regimes.

Specifically, these principles are as follows:

1. Any conversation on housing finance reform should begin with a discussion of its potential impact on borrowers and the availability of long-term fixed-rate credit products.
2. Any legislation should articulate a clearly-defined government role in the mortgage market that focuses on ensuring uninterrupted liquidity in secondary markets for mortgage-backed securities (MBS).
3. SIFMA and its members believe that, to retain the high levels of liquidity in today's marketplace and protect and preserve the TBA market, any housing finance legislation should establish an explicit and appropriately-priced government guarantee for qualifying MBS.
4. A government guarantee should be structured to protect taxpayers from an undue amount of risk through private-sector risk sharing arrangements.
5. Congress should establish a clear and limited role for well-capitalized intermediaries to support a deep and liquid market.
6. In addition, to further reduce taxpayer risk over the long-term, Congress should encourage the return of additional private capital to the mortgage market through the establishment of policy certainty and a well-functioning infrastructure with proper alignment of incentives.
7. Finally, any legislative reforms to the housing finance systems should be undertaken in a deliberate and thoughtful way, including an orderly transition from the current system to the new system and fungibility of existing GSE MBS with any future MBS.

We will now discuss each of these principles in more detail.

Any conversation on housing finance reform should begin with a discussion of its potential impact on borrowers and the availability of long-term fixed-rate credit products. For most Americans, the purchase of a home is the most significant purchase they will undertake over the course of their lives and for the vast majority, a 30-year fixed-rate mortgage may make the most sense. As such, SIFMA and its members believe that preserving broad access to an affordable 30-year fixed-rate mortgage should underpin any legislative effort to reform our housing finance system. It should be noted, however, that 30-year fixed-rate mortgages pose significant interest rate and other risks to lenders and investors due to the long maturity period, the possibilities of both default and prepayment, and borrower refinancing stemming from changes in interest rates. It is important that the secondary market architecture help lenders and investors manage these risks, because without mechanisms to manage them, many lenders would be unwilling to originate 30-year fixed rate loans and might exit the market for long-term mortgages completely.

The primary focus of SIFMA has been and will continue to be the preservation of a highly liquid TBA market, which provides a number of important benefits to consumers, lenders, and the economy. The TBA market is a roughly \$5 trillion market that helps borrowers by facilitating the advance sale of conforming loans. The forward nature of this market allows originators to offer borrowers interest rate locks well in advance of closing. The TBA market is a national market so regional differences in credit availability are smoothed by the geographic diversity of mortgages underlying a MBS. The TBA market also benefits end investors, including 401(k) plans, pensions, and mutual funds, by allowing them to buy MBS with clear, predictable terms on a regular basis to meet their own portfolio diversification needs. And because the TBA market is so liquid – over \$200 billion of securities traded on an average day in 2016 – end investors do not demand steep liquidity premiums, further driving down the costs to borrowers.

Homogeneity is what makes the TBA market succeed. Because securities are sold in advance, buyers and sellers agree on certain terms of a trade, but buyers do not know – and do not need to know – all the characteristics of the security they have purchased. Instead, buyers receive information about the security two days before the trade settles. Today, mortgage origination terms are standardized through the GSEs. GSE-mandated standards help create homogeneity in terms of form (structure and payment dates) and underlying contractual provisions (documentation, pooling, servicing, and disclosure). These standards mean that investors can purchase MBS in the TBA market with confidence that these securities will meet a certain minimum standard of quality regardless of who originates the mortgages.

Any legislation should articulate a clearly-defined government role in the mortgage market that focuses on ensuring uninterrupted liquidity in secondary markets for MBS. A vibrant secondary market will benefit all market participants – borrowers, originators, lenders, investors, and intermediaries – and clarity on the government’s role will allow all market participants to hedge the risks that accompany their position in the market, and for the private sector to develop around it. A clearly-defined government role will also help attract private capital to the mortgage market and help rebuild the market for private-label MBS.

SIFMA and its members believe that, to retain the high levels of liquidity in today’s marketplace and protect and preserve the TBA market, any housing finance legislation should establish an explicit and appropriately-priced government guarantee for qualifying MBS. The TBA market is enabled by a government guarantee on the principal and interest payments of qualifying MBS. This guarantee promotes homogeneity by allowing investors to look beyond idiosyncratic credit risk and instead focus on the risk that loans will prepay at a faster or slower rate than expected, behavior in large part driven by changes in the interest rate environment. These investors, so-called “rates investors”, may not have an interest in or appetite for the credit risk that is required for investments in, for example, the non-agency MBS market. Without a guarantee, large swaths of investors, both U.S.-based and global, would look to other products for their investments.

This explicit and appropriately priced guarantee will maintain liquidity and confidence in the secondary market, reduce interest rates for borrowers, and encourage investors to supply credit by allowing them to focus on prepayment and interest rate risks. Absent a government guarantee, the market will be required to price credit risk –including catastrophic credit risk – into mortgage interest rates, which will reduce the availability of credit and weaken investor appetite for even the safest MBS. The guarantee will also provide critical countercyclical support for the market in times

of crisis, and allow investors to fund mortgage credit creation during contractions of private capital availability. In 2008, as the private-label MBS market receded and banks withdrew, the GSE and FHA markets continued to facilitate loans. If the GSE and FHA markets had not been able to step into the downturn, mortgage credit would have completely dried up and many Americans would have effectively been unable to purchase homes.

A government guarantee should be structured to protect taxpayers from an undue amount of risk through private-sector risk sharing arrangements. The government should require that for a MBS to qualify for a guarantee, it must have levels of private capital in front of the guarantee to protect taxpayers, including borrower equity and fees paid by lenders to obtain a guarantee. Additionally, intermediaries should be required to conduct CRT to ensure that taxpayer exposure is focused on catastrophic risk, not first-loss risk. We believe the adoption of both front and back-end CRT by the GSEs has been an important step towards a safer secondary market. Congress should encourage existing CRT practices as well as continued innovation in the transfer of credit risk. We believe that innovation is still to be encouraged in this regard – various forms of risk sharing have their benefits and risks, and it is not yet time to call the markets mature and pick a winner. Additionally, we believe that policymakers can take steps to improve their liquidity by eliminating roadblocks to new structures, such as commodity pool regulations; broadening the investor base for CRT by making CRT more attractive to mortgage REITs; and making capital requirements for the securities less punitive for banks, among other things. Investors prize liquidity in the markets in which they invest – more liquidity will bring more investors, lowering the cost of CRT.

It is also important that any credit risk sharing not have a pro-cyclical impact on the availability of credit. Requiring fixed levels of risk sharing or setting mandatory amounts of CRT for intermediaries to conduct for a given security could cause insurance premiums to rise in periods of market stress, hurting the availability of credit at the worst possible time. Instead, targeted levels of risk sharing should include off-ramps and provisions that allow regulators to temporarily adjust or suspend requirements should market conditions dictate this. Congress should also try to gradually increase the exposure of private capital to credit risk in the housing market, and be cognizant that investor appetite for first-loss positions in MBS, however secure, will have limits. Additionally, to preserve the functioning of the TBA market, Congress should continue to allow CRT to be conducted after a loan is bundled into a security.

Congress should establish a clear and limited role for well-capitalized intermediaries to support a deep and liquid market. There have been several thoughtful proposals in recent years about intermediary entities that are worthy of consideration, SIFMA believes that whatever entity stands between originators and the taxpayers should be a) well capitalized and b) dedicated to its securitization and standard-setting mission to ensure that the market for origination remains competitive.

Today, Fannie Mae and Freddie Mac play this role, aggregating mortgages into securities including through their cash window – an important feature for smaller lenders to access the securitization market. Absent this cash window, small lenders, including community banks and credit unions, would face a steep, and potentially insurmountable disadvantage when accessing the secondary market. Intermediaries will likely need small, limited portfolios to maintain a cash window and small portfolios may be needed for credit risk transfer facilitation. In either case, they should not be able to leverage portfolios as proprietary investment vehicles. Intermediaries also have an

important role to play in setting industry-wide standards, much as they do today. Standardization of loan documentation, data, and other processes has been one of the key benefits of the current system.

While the GSEs have been in conservatorship for nine years, the enterprises and FHFA have undertaken important administrative actions that have improved the soundness of the entities and the durability of the housing finance system broadly. We believe these reforms – or some equivalent version of these reforms – should be preserved under any new system and applied to or used by future intermediaries. We have already mentioned the CRT program, and the GSEs have begun modernizing their securitization infrastructure, which was needed given the age of existing GSE systems. This Common Securitization Platform will likely be a valuable asset in any future system.

In addition, to further reduce taxpayer risk over the long-term, Congress should encourage the return of additional private capital to the mortgage market through the establishment of policy certainty and a well-functioning infrastructure with proper alignment of incentives. Today, private-label securities are but a small corner of the market. We believe that in the long-term, this situation is suboptimal and must improve. Creating the conditions for a well-functioning private label market is an important component of housing finance reform. Housing finance legislation should aim to involve new sources of private capital while being careful not to repel private actors or generate uncertainty for investors. Regulatory policies that recognize and respect the rights of investors are critical to attracting private capital to the housing markets. Creating policy certainty should be a primary goal of housing finance reform, as the lack of certainty has been a core driver of the weakness of the non-government MBS markets post-crisis.

We believe there are a few key principles here:

- Investors in private label MBS need to understand what they are buying, through clear and transparent disclosure and clearly defined rights and obligations of transacting counterparties that is as standardized as is reasonable, and through the establishment of more nationally uniform rules around activities such as mortgage servicing as opposed to the hodgepodge of rules that exist today at the national, state, and local levels.
- Investors need to trust that rules of the game will not change after the fact; for example, that their rights will be respected in policy actions including legal and regulatory settlements, or that their investments will not be threatened by irresponsible abuse of eminent domain.
- Investors need to believe that policymakers share the goal over the long term of creating a vibrant and liquid non-government mortgage securitization market. Investors will not return in size to these markets unless they believe the markets will be around for the long term.

Finally, any legislative reforms to the housing finance systems should be undertaken in an orderly and thoughtful way, including an orderly transition from the current system to new system and fungibility of existing GSE MBS with any future MBS. There is tremendous downside risk of a disorderly transition, and turmoil in the housing market would penalize Americans in the market for a home. In our view, policymakers focused on creating a new system should be just as mindful of how we transition to the new system as they are on what the new

system will look like. There is currently over \$4 trillion in outstanding Fannie Mae MBS and Freddie Mac participation certificates held by investors globally. There are hundreds of billions of dollars of newly originated securities issued by the GSEs each year. It is imperative to avoid disruption to the housing finance market and to ensure the continuity of liquidity that the market currently supports. This requires clear and simple fungibility between current securities and any new securities, if they take on a different form; a full faith and credit guarantee on the current securities; and an appropriate transition time.

In the secondary market, the best way to ensure a safe and orderly transition is to assure investors that existing GSE MBS will be fungible with any future MBS. Abandoning outstanding securities could irreparably harm confidence by investors for new securities, and any security would launch with no liquidity – a dangerous outcome for all market participants, including borrowers. It is possible that the transition period is necessarily a lengthy one, but we believe that to ensure the smooth functioning of our markets, it is better that the transition be long and cautious, as missteps could harm investor confidence in the new system and create serious distortions in the housing market.

In conclusion, the current circumstances are very different from 2008 when the GSEs were first placed into conservatorship, and we are now in a better place. The housing markets have largely recovered, the financial conditions of the GSEs has stabilized, and the GSEs have undertaken a number of important reforms. That said, Fannie Mae and Freddie Mac remain in an uncertain state of conservatorship. SIFMA and its members believe the time for reform is now and we stand ready to assist the Committee in this undertaking.