Testimony of

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of the Committee on Financial Services

Hearing on

"The U.S. Housing Finance System in Global Context: Structure, Capital Sources, and Housing Dynamics"

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Good morning, my name is Michael Farrell, and I am the CEO of Annaly Capital Management, the largest residential mortgage Real Estate Investment Trust (or REIT) in the country. Through Annaly and our subsidiaries and affiliates we own or manage a wide range of mortgages and other real-estate related assets, including Agency and non-Agency residential mortgage-backed securities (or MBS).

I represent the mortgage REITs and other secondary mortgage market investors who provide the majority of the capital to finance America's homes. Through our MBS holdings my company and its affiliates alone are responsible for funding almost a million American households.

At this point in history, while our nation's banks have about $13 trillion in total assets, the amount of mortgage debt outstanding totals about $10.5 trillion. There isn't enough capacity in our banking system to hold the outstanding mortgage debt, and as a result about two-thirds of that total, or $6.8 trillion, is held in securitizations--$5.5 trillion in Agency mortgage-backed securities and the balance in private label mortgage-backed securities. The American mortgage finance system needs to have effective long-term holders of mortgage credit outside of the banking system. It is thus axiomatic that without a healthy securitization market our housing finance system would have to undergo a radical transformation.

Some have argued that this should not be a problem because other countries have similar home-ownership rates and manageable mortgage costs. These arguments miss some very significant points.

First, the US mortgage market is unique. In the US, securitization is the largest mortgage funder with banks a distant second, while Europe is almost the exact opposite, with about two-thirds of mortgages funded by bank deposits, covered bonds a distant second and very little securitization. So the European model is largely dependent on the deposits and individual credit ratings of European banks. As proof, consider that in the US, bank assets total about 80% of GDP, while in Canada, Denmark, France, Germany and Spain bank assets are anywhere from two to four times GDP. Moreover, most mortgages in other countries are recourse to the borrower, shorter-term, prepayable only with a penalty and variable-rate, which makes it a much different product than the typical American mortgage, with much different risks for the borrower and the lender.

Second, our current housing finance system is the most efficient credit delivery system in the world. Securitization allows borrowers of similar creditworthiness using similar mortgage products to receive the benefits of scale in pricing. In addition, the government guarantee to make timely payments of interest and principal on a large portion of these mortgages scales the process even further. The TBA, or to-be-announced market, is the window through which much of this scale occurs; it maintains a consistent underwriting standard, levels the playing field for smaller loan originators and community banks and enables lenders to offer longer rate-locks to borrowers. It is an important tool for making possible the availability of the very popular 30-year fixed-rate, prepayable, mortgage with a manageable down payment for a wide swath of creditworthy borrowers.

Third, unlike the smaller, domestically financed housing markets of other countries, our system attracts a much broader investor base for residential mortgages, including institutional investors here and around the world. These investors include US and foreign banks, central banks and sovereign wealth funds, mutual funds, state and local governments and the GSEs themselves. According to Freddie Mac, foreign investors constitute the third largest single holder of Agency MBS. What attracts these investors to fund US residential mortgages? It is the size, scale and flexibility of the Agency MBS market, its homogeneity, liquidity, ease of pricing and, importantly, their capital risk-weightings.

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: Not at the same level of mortgage rates and not in the same size. Many, if not most investors in Agency MBS won't invest in private label MBS at any price or only in reduced amounts because of their need for liquidity or the restrictions of their investment guidelines. Some of these so-called "rates investors" could cross over, and investors in other asset classes might be attracted to a deeper private label MBS market, but we can't say for sure how many or at what price or in what time frame. Analysts at Credit Suisse have estimated that US housing could lose roughly $3 to $4 trillion in funding from domestic and foreign investors if Agency MBS were replaced by credit-sensitive products. The impact of this loss could have adverse consequences for the housing market and the economy for years to come.

In conclusion, the American mortgage market and the sources of funding for America's mortgages are unique. The domestic and global investors who provide so much capital to buy American homes will adapt to whatever Congress decides to do with housing finance policy, but they may adapt by not investing at all. I believe that a housing finance system that does not include the homogeneity and liquidity made possible by government involvement will be smaller and more expensive, with potentially negative consequences for home prices and homeowner flexibility.

I welcome any questions you may have.

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United States House of Representatives
Committee on Financial Services

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Michael A.J. Farrell	Annaly Capital Management
3. Business Address and telephone number:	
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4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
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