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Before the
Committee on Finance
United States Senate

Hearing on
The Housing Decline: The Extent of the Problem and Potential Remedies
December 13, 2007

Good morning Chairman Baucus, Ranking Member Grassley and other members of the Committee. Thank you for the opportunity to testify today about the mortgage securities markets and tax proposals related to providing relief to homeowners in need of assistance. SIFMA[1] looks forward to working with you and the Committee on these proposals, just as we continue to work with Banking Committee Chairman Chris Dodd, who introduced comprehensive legislation this week, and Ranking Member Richard Shelby on subprime mortgage reform legislation and related housing matters.

The U.S. system of supplying credit for homebuyers has undergone a fundamental transformation over the last 20 years. Mortgage lending has gone from a business dominated by thrifts and other "portfolio" investors to one dominated by securitization. This transformation has reaped numerous benefits for homebuyers, investors and the economy as a whole. Until the subprime mortgage downturn this year, securitization was responsible for supplying more mortgage credit at a lower cost for disadvantaged families than would have ever been possible under the old "originate and hold" model.

Millions of eligible families have been able to purchase homes as a result of subprime mortgages and mortgage-backed securities. However, it has become clear that underwriting standards were, at times, too loose at the peak of the housing boom; subprime loans that should not have been made were made. This happened as a result of a combination of a period of historically low interest rates, overly optimistic assumptions, fraud or abuse on the part of both lenders and borrowers, speculation and an underpricing of credit risk brought about by a glut of investment capital from around the world seeking attractive rates of return.

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington, D.C., and London, and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

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As it became apparent earlier this year that defaults and foreclosures in the subprime mortgage sector were spiking, the market for securities backed by subprime loans changed direction very quickly. Today, virtually no subprime mortgages are being originated. The securitization market for new subprime loans has shut down. The values of outstanding securities backed by subprime mortgages have dropped dramatically, and market liquidity—the ability to seamlessly trade securities in the secondary market—has dried up. Moreover, the deterioration of the subprime lending market has bled over into other credit sectors such as prime mortgage lending, commercial lending and corporate bonds, not just in the U.S. but in Europe and elsewhere as well. As one indication, the volume of asset-backed commercial paper outstanding has dropped from $1.2 trillion just four months ago to $800 billion today.[2]

Despite the severe downturn in the subprime market experienced this year, subprime lending has served the needs of homebuyers with weak credit; a large majority of subprime borrowers are able to pay their loans on time, and have been able to achieve the dream of homeownership. As indicated by the Mortgage Bankers Association's[3] most recent *Delinquency Survey* over three-quarters of outstanding subprime loans remain current.

The downturns in the subprime mortgage market and the credit markets more broadly have raised some questions regarding, for example, how thinly traded securities—in some cases, securities that were never designed to be traded at all—can be valued in difficult market conditions, or how the market can ensure that investors and others have adequate access to information on the structured securities they hold. SIFMA members and other market participants take these questions seriously, and we are working on solutions that will improve market practices without threatening the benefits of securitization for consumers and the economy as a whole.

Of note, Treasury Secretary Paulson announced last week a multi-pronged plan to assist struggling homeowners who will face a mortgage reset with a rising interest rate. The Treasury Department has proposed an expanded use of the qualified Mortgage Revenue Bond (MRB) program to help such homeowners refinance their subprime loans.

Tax-exempt qualified MRBs, issued by State and local government Housing Finance Authorities, are an important tool to finance low-cost mortgage loans for low- and moderate-income families. Under current law, qualified MRBs support new mortgages for first-time homebuyers for owner-occupied single-family homes. The proposal announced by Treasury would grant flexibility to State and local government authorities to issue tax-exempt MRBs to refinance existing subprime loans.

As Congress continues to explore efficient and flexible solutions for troubled homeowners, we support the idea of using tax-exempt bonds to accomplish this goal. The refinancing of existing loans to a lower interest rate remains a preferable outcome for troubled borrowers. We respectfully urge the Finance Committee's adoption of this proposal, and to consider exempting refinancing

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[2] Source: Board of Governors of the Federal Reserve System.
[3] Mortgage Bankers Association, *National Delinquency Survey, Q307*, December 6, 2007, page 5. Includes total delinquencies and foreclosures.

MRBs from the AMT to ensure market demand for these securities.

Background

Mortgage-backed securities (MBS) are securities backed by the cash flows from pools of mortgage loans. They are sold to investors much like stocks, government and corporate bonds, and other financial instruments, and are often structured to address a particular investor's risk preferences. The U.S. government has supported and encouraged the development of the MBS market by creating Fannie Mae, Freddie Mac and Ginnie Mae and by enacting other laws such as the Secondary Mortgage Market Enhancement Act of 1984 and the real estate mortgage investment conduit (REMIC) provisions of the Tax Reform Act of 1986 designed to facilitate the securitization of residential mortgages. The policy goal of these initiatives is to expand the availability of credit to home-buying families and reduce the cost of that credit.

Approximately $11 trillion of home mortgage debt was outstanding as of September 30.[4] As of the third quarter of this year, approximately $7.1 trillion of mortgage-related securities were outstanding compared to $4.4 trillion of U.S. Treasury securities and $5.7 trillion of corporate debt,[5] so about 65 percent of outstanding home mortgages are securitized. Securitization and the development of the secondary mortgage market have played a critical role both in expanding home ownership and in diversifying systemic risk within the banking system.

The capital provided to lenders by the secondary market through loan purchases and mortgage securitization has enabled larger segments of Americans to achieve the dream of home ownership. The secondary market has been critical in making affordable mortgages available to borrowers of all walks of life. From 1995 to 2005, the subprime mortgage loan market grew from $65 billion to $665 billion, dropping to $600 billion in 2006.[6] This growth was assisted by the funding provided through securitization for loans to subprime borrowers; issuance of MBS backed by subprime loans grew from $18 billion in 1995 to $508 billion in 2005, dropping to $483 billion in 2006.[7]

In addition to providing capital to facilitate the growth of home ownership, the secondary mortgage market and securitization have decreased systemic risk attributable to mortgage lending. The more efficient allocation of risk to both national and international investors through securitization reduces the concentration of risk that would otherwise be borne solely by local or national financial institutions due to fluctuations in local real estate markets. Such concentration of risk has caused problems in the past, most notably in the 1980s during the savings and loan crisis. Purchasers of MBS include institutional investors such as pension funds, investment funds, banks and insurance companies, both throughout the United States and increasingly throughout the world. Holdings of

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[4] Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States*, December 6, 2007, page 93.
[5] Securities Industry and Financial Markets Association, *Research Quarterly*, November 2007, page 1.
[6] Inside Mortgage Finance Publications, *The 2006 Mortgage Market Statistical Annual, Volume I: The Primary Market*, 2007, pages 209-222.
[7] Inside Mortgage Finance Publications, page 3.

mortgage related securities are dispersed across a broad spectrum of industries and regions, with more than 15 percent held overseas.

Before securitization became prevalent, banks funded extensions of mortgage credit through their customers' deposits, and mortgage credit availability was dictated, in part, by the volume of bank deposits. Today, banks and other lenders have the option to sell their loans into the secondary market, facilitating the issuance of new mortgages and the dispersion of local lending risk.

The Subprime Downturn

By late 2006 and early 2007, the nationwide boom in residential real estate prices had come to an end. Average home sale prices nationwide have been on a steady decline in 2007, falling 4.2 percent in the 12 months preceding September of this year[8] after several years of annual increases in the neighborhood of 10 percent. This turnaround in real estate prices threatened the financing strategies of many subprime borrowers who had anticipated being able to sell their home at a profit or refinance into more affordable mortgage products based on a presumption of ever rapidly increasing home values. As home prices flattened out and then began to fall, delinquency rates on subprime loans steadily increased.

The effect in the capital markets was a drop in the value of securities backed by subprime loans. Figure 1 shows the value of the Markit ABX-AAA-HE 07-1 index, a market index of AAA-rated securities mostly backed by subprime mortgages. The index has declined in value more than 20 percent since June.

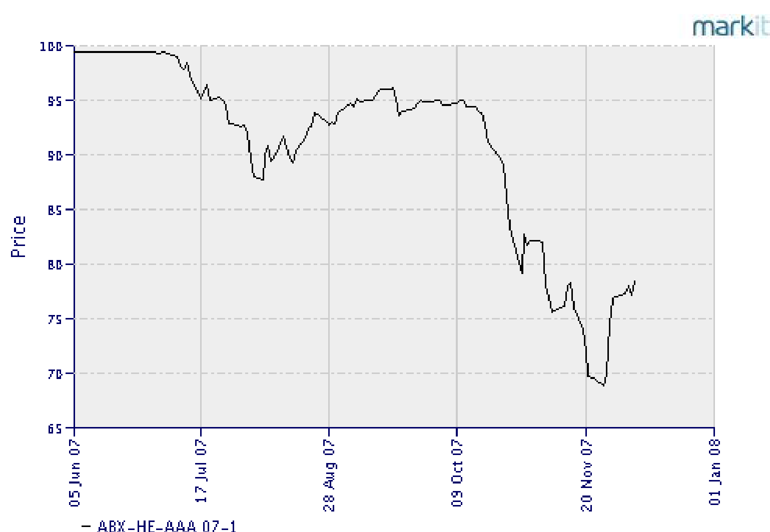

Figure 1.[9]

[8] National Association of Realtors, "Mortgage Availability Improving But Hampered September Existing-Home Sales," News Release, October 24, 2007.
[9] Source: Markit Group Limited.

The performance of lower rated securities has been even more severe. Figure 2 shows the value of the Markit ABX-BBB-HE 07-1 index of BBB-rated securities backed mostly by subprime loans. That index has lost 80 percent of its value since its creation earlier this year.

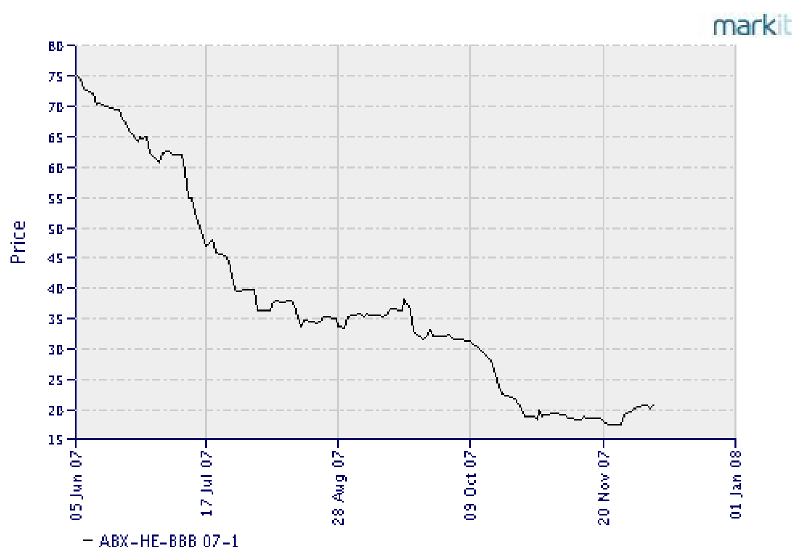

Figure 2.[10]

The spike in subprime defaults has also been reflected in downgrades of credit ratings on subprime-backed securities and other credit products. Deutsche Bank reported recently that there have been nearly 20,000 separate downgrades of subprime-backed securities and other credit products so far this year compared to around 2,500 for all of 2006.[11] Deutsche Bank concluded that "downgrades of collateralized debt obligations and sub-prime residential mortgage-backed securities accounted for nearly 75 percent of all volume-weighted downgrades this past year, and that it was even more alarming the degree to which very highly rated securities seem to have deteriorated overnight."[12]

Investors in subprime-backed securities have clearly suffered as a result of the market downturn. Estimates of total losses expected to be sustained by the global economy as a result of the correction in the credit markets sparked by the subprime downturn range from $150-400 billion.

Resolution

Currently there is an inventory of nearly 4.5 million existing homes for sale nationwide, a 10.8 month supply, compared to 3.9 million, or 7.4 months, a year ago and an average of 2.2 million, or 4.3 months, in 2004.[13] Reducing the inventory of new and existing homes for sale is key to an overall turnaround in housing. Home prices will need to continue to adjust to draw buyers to the market and reduce supply.

[10] Source: Markit Group Limited.
[11] Duncan Kerr, "Investors 'Stunned' by 20,000 Ratings Cuts," *Financial News*, December 5, 2007.
[12] Duncan Kerr.
[13] National Association of Realtors.

At the same time, a deleveraging and recognition of losses, already begun at banks, securities firms, investment funds and others affected by the credit downturn, will help alleviate constraints in the supply of credit. Fortunately, despite perceptions to the contrary, overall credit in the U.S. is not contracting. The Federal Reserve reported recently that total borrowing in the U.S. in the third quarter expended at an annual rate of nearly $5 trillion in the third quarter, higher than any of the previous six quarters, despite a significant increase in the cost of credit across the board this year.[14] The Fed's monetary policy response to the downturn, cemented this week with another reduction in the funds and discount rates, will continue to provide a needed stimulus.

Conclusion

The evolution of mortgage securitization has been one of the most remarkable developments in the financial markets of the last 25 years. The mortgage securities market, now the largest sector of the U.S. fixed-income market, has brought benefits to homebuyers and has reduced risks for banks, thrifts and others engaged in home lending. Despite the downturn in the subprime mortgage market and the broader real estate sector, securitization will continue to provide a ready supply of capital to consumers and others.

[14] Board of Governors of the Federal Reserve System, page 9.