October 31, 2013

Please contact the author below if you have questions regarding this alert.

Authors:

Andrew Olmem
aolmem@Venable.com
202.344.4717

Joanna P. Breslow Boyd*
jpboyd@Venable.com
202.344.4715

*Bar Admission Pending

Banking Committee Examines Government Guarantee for Mortgage-Backed Securities

Today, the Senate Banking Committee held a hearing entitled "*Housing Finance Reform: Essential Elements of a Government Guarantee for Mortgage-Backed Securities*." This is the second hearing this week on housing finance reform. The witnesses were: Mr. Joseph Tracy, Executive Vice President and Senior Advisor to the President, Federal Reserve Bank of New York; the Honorable Phillip L. Swagel, Professor of International Economic Policy, University of Maryland School of Public Policy; Mr. Michael S. Canter, Director of Securitized Assets, AllianceBernstein, on behalf of the Securities Industry and Financial Markets Association (SIFMA); and the Honorable David H. Stevens, President and CEO, Mortgage Bankers Association (MBA).

Chairman Tim Johnson's (D-SD) opening statement commended Senators Mark Warner (D-VA) and Bob Corker (R-TN) for their legislation (S. 1217, the Corker-Warner legislation) that would formalize a federal backstop for the mortgage market. He emphasized, however, that it is critical to get the details right on how to structure a new guarantee, particularly on how private capital would hold the first loss position. In his opening statement, Ranking Member Crapo (R-ID) indicated his interest in understanding more how the Corker-Warner legislation interacts with the To-Be-Announced (TBA) market, and stressed that any legislation must permit the TBA market to thrive. He also cited the Freddie Mac STACR deal and the Fannie Mae NMI & C-Deals as examples of how private capital can participate at greater levels in the secondary market.

Mr. Tracy supported legislation making the current implicit federal government guarantee of the housing market explicit since, in his view, the government will always intervene when truly systemic housing shocks occur. He advocated making the government guarantee credible and known in advance, and recommended that the mechanism for triggering the backstop be when a specific amount of losses occurs across an entire group or vintage of mortgage-backed securities (MBS), rather than based on the performance of a particular security or an issuer.

Dr. Swagel concurred that an explicit government guarantee is necessary, but emphasized that such a guarantee should be invoked only for truly extraordinary events. He supported the proposed 10 percent first-loss private capital requirement at the MBS level to protect taxpayers. He disputed claims that a 10 percent requirement would raise interest rates unduly or is unfeasible.

Speaking on behalf of SIFMA, Mr. Canter stressed the importance of supporting the ability of the secondary market to support the 30-year fixed rate mortgage, in which the TBA plays a crucial role. Mr. Canter argued that there should be a small number of private guarantors, because too many could cause a race to the bottom in pricing and underwriting standards.

Finally, Mr. Stevens stated that the secondary market requires a government guarantee for MBS, but that private capital should stand in front of any government backstop. He also recommended that capital requirements in the secondary market be in line with the Basel standards to ensure that capital standards for mortgage credit risk are the same regardless of charter type.

Following the testimony, there was an active question and answer session. During the questioning, Chairman Johnson asked Mr. Stevens about his reservations about a 10 percent flat line capital requirement, to which Mr. Stevens responded that it was insufficiently flexible for mortgage loan-to-values that carry varying levels of risk. Senator David Vitter (R-LA) stated his eagerness to move to a markup, calling the Corker-Warner legislation a "very strong and positive starting point," and expressing his hope that the taxpayer protections in the bill would not be "eroded in any way." Senator Warner asked the panel whether they believed that bond guarantors should be required to fail before the government backstop is trigger; all witnesses responded in the affirmative. Senator Elizabeth Warren (D-MA) also delved into the differences between two proposed triggers for the government guarantee: a structured transaction model in which the government steps in whenever a particular MBS fails, or a mutual/bond approach that requires the failure of issuers/guarantors or MBS vintages before the government intervenes. Calling this a "Goldilocks problem," she asserted that the former option may have the government intervening too often with too little consequences, while the latter risks the government intervening too late and after the market has experienced serious distress.

If you have any questions about this alert, please contact the authors.