FACILITATING CONTINUED INVESTOR DEMAND IN THE U.S. MORTGAGE MARKET WITHOUT A GOVERNMENT GUARANTEE

FIELD HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

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FACILITATING CONTINUED INVESTOR DEMAND IN THE U.S. MORTGAGE MARKET WITHOUT A GOVERNMENT GUARANTEE

Wednesday, September 7, 2011

U.S. House of Representatives,
Subcommittee on Capital Markets and
government Sponsored Enterprises,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:17 a.m., at the National Museum of the American Indian, The George Gustav Heye Center, Alexander Hamilton U.S. Custom House, One Bowling Green #1, New York, New York, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Schweikert, Neugebauer, Hayworth; and Maloney.

Also present: Representative Velazquez.

Chairman Garrett. Good morning. This field hearing of the Subcommittee on Capital Markets and GSEs is called to order.

I welcome everyone to the field hearing and thank you for coming out. And I also appreciate all the panelists who joined us this morning as well.

So we will begin, as is the custom, with opening statements for those members who would like to make opening statements and then go from there to our panel.

Thank you.

And so, as we begin, and as we all sit here, we remember that it was on this day, almost exactly 3 years ago, that the mortgage giants Fannie Mae and Freddie Mac were placed in conservatorship by the Federal regulator. And $170 billion in taxpayer bailouts and counting since then, these two entities continue to do what? To bleed billions of dollars of losses each quarter, with no end in sight.

Both of these companies combined, as we know, with FHA, guarantee or insure around 95 percent of the U.S. housing market. And so, when you think at the time when this country is facing huge Federal deficits, the last thing that we should be doing or even contemplating is permanently adding an additional $11 trillion of expenses and exposures to the Federal Government.

There is widespread agreement, it seems, that the government cannot and should not back our entire mortgage marketplace, and we all agree with that. I realize that winding down these two companies must be done appropriately, though, and, as I have said repeatedly, done so over time.

And why do we do that? Basically, to ensure that you have a relatively smooth transition, if you will, to a new system, one that would be a new system backed by private capital. But we need to begin this transition to that period now. And waiting, as some have suggested, will only make it worse and more difficult to transition by ensuring that market participants are more reliant on the government.

So, that is why we are all here today, here in New York City, in the world's financial capital, to examine ways to encourage private capital, private investment to reenter our Nation's mortgage market and ensure that we have a robust level of private investment in this market and will remain in the mortgage market without any more government backstop.

There are a number of reasons why government investment has been slow to return to the housing sector. I would look at those and say, first and foremost above those, I believe, is the government's expanded role in the mortgage market. That has acted as a roadblock or a hindrance, if you will, to private capital coming back into the marketplace.

When issuers can find mortgages more cheaply, as they can by using the taxpayers, it is really not surprising at all for them to go that route. So, at the end of this month, an extremely modest drop in the conforming loan limits, as we all know, is set to occur. And what will it do? It will show that private capital can, indeed, fill that segment of the marketplace and that rates will not skyrocket for those borrowers, as some people would believe.

This will be a good—albeit small, but necessary—first step towards weaning, basically, the mortgage market off of the guarantee of government support back to a more private capital support.

But to make significant headway in our efforts to move the secondary mortgage market back to this, where we would like to go, the private sector, we must do certain things. We must reform the private securitization market and make sure that investors feel basically comfortable with returning to the marketplace where they had so many bad experiences over the last several years.

What do we need to do? I believe one negative aspect of the securitization market that could be improved upon is the lack of transparency in the marketplace today. Basically, too many times during the housing run-ups that we have seen, investors were sold securities where the underlying collateral specifics were not properly known or shared, and they were rushed through into purchasing bonds without having time, basically, to review them and did not have the prices of other trades on similar products available to them at the time.

So, what do we do? First, by providing investors more transparency and additional disclosures, I believe investors will be able and more willing to return to our mortgage securitization marketplace.

Second, another area that needs to be addressed is the lack of legal clarity for these very same investors. Unfortunately, the rule of law has come into question not only in this area, but in a lot of other areas as well over the last several years, and many investors have had their rights, you could say trampled upon in the aftermath of the housing market bubble.

For investors to feel comfortable again with investing in the private securitization marketplace, what do we need to do? There must be legal clarity, and conflicts of interest between the various parties must be addressed and minimized and mitigated.

And finally, I believe that increased standardization and uniformity within our securitization market will help as well. What will it do? It will help drive long-term and robust investment back again. Even with Fannie and Freddie's many defaults, I do believe, that there were some benefits. They did provide some benefits in the marketplace through their standardization of underwriting criteria, as well as government documents of securities.

I believe that if this uniformity was replicated in some way in the private sector market, the market would become much more liquid, which is what you want to get to, and many investors around the world will once again feel comfortable in participating in that marketplace.

I look forward to the hearing and I look forward to the testimony from our esteemed panel that we have here today on specific steps that Congress can take to advance these ideas and fix the so-called plumbing, if you will, of the securitization market.

I am also interested in discussing and addressing ideas to do what? To facilitate the creation of a TBA market, the "to be announced" market, which we have previously.

Some people raise questions as to how that will be structured or exist going forward. You can do that by replicating the sameness or the homogeneity and uniformity within the GSE markets as well. So, what do we need to do over there?

One final side note, but related to this, there has been some news, I would say disturbing news from the Administration in contemplating the United States using the GSEs, if you will, to conduct a backdoor approach to the stimulus program. Of course, we will hear this fleshed out on Thursday, I presume, when the Administration, when the President gives his speech as to what he feels needs to be done with regard to job creation and stimulus.

But there are some rumors out there, and the idea that was floated out—by forcing, on the breaking of any legal and binding contracts and requirements on these securitizations, basically, for the GSEs to forfeit their legal standing on claims to banks that sold them these loans, additionally.

What would this do if it were to go through? This would potentially subject the GSEs to billions of dollars of additional losses, and those losses would be passed on to whom? Of course, they would go directly to the American taxpayers in the end. So, we will be carefully watching that.

Fannie and Freddie, if you look at them and how they have been used over the years by decades, by past Administrations, and now potentially for this, you have to look at them and say they are not just entities to be used any way you want. They are not just toys, as some say, to use to test into new ways, to various new social policies, new social policies' experiments.

What they are, in fact, are two failed companies that played a leading role in the crisis of September of 2008, leading to the financial difficulties that we still find ourselves in as a country right now. And so, at a time when we are trying to get private investment back into the housing market, the last thing we need to do is to give investors yet another reason not to buy U.S. mortgages.

With that, again, I thank you all for being here, and I turn to a member who, as you said, makes this meeting today a bipartisan discussion on GSE requirements.

Ms. Velazquez, you are recognized.

Ms. VELAZQUEZ. Thank you, Mr. Chairman, for coming to New York City to hold this important hearing and for inviting me. I don't sit on this subcommittee, but I sit on the Financial Services Committee.

We are here today to examine the conditions necessary to restore a vibrant private market for residential mortgage-backed securities. Just 5 years ago, this market was valued at over $1.43 trillion. In the years since, we have lost over 97 percent of this value.

Our economic troubles started with the housing sector, and most economists agree that we will not see a return to prosperity until the housing market has recovered. To do so, investors must be able to once again buy and sell these assets with confidence.

Mortgage servicers must be empowered to restructure and work out troubled loans. And homeowners must have a clear means of knowing who to contact to prevent a wrongful foreclosure. Until these conditions are met, the housing sector will continue to drag on our recovery.

While privately issued mortgage securities comprise just 12 percent of the first lien market, they represent 40 percent of the loans that are currently 60 days or more past due. These numbers illustrate the depth of the challenge facing private mortgages securities. It also highlights the demands these mortgages are placing on servicers.

Servicers are overwhelmed with the sheer number of problem loans they must handle on a daily basis. Unfortunately, for many homeowners, these numbers have resulted in rampant problems in the foreclosure process. Members of this committee are all too familiar with the issues of illegal foreclosure and the debacle caused by robo-signing.

To address these problems, some have proposed establishing national standards for mortgage servicing, including improved accounting and reporting requirements. While these proposals are encouraging, these proposals must also include enhanced restructuring and loan modification requirements for troubled loans and provisions to ensure that servicers act in the best interests of investors and homeowners.

Problems in the RMBS market are not limited to servicers. There is broad agreement on both sides of the aisle that, while necessary, the government's current role in this market should not be made permanent. Few policymakers will support a system where the Federal Government guarantees 95 out of 100 of mortgages issued.

Our efforts to reverse this trend and to strengthen our housing market must acknowledge that the private market will not return without the participation of investors. By improving transparency and disclosures in the securitization process, we can begin to address investors' fears in the market and encourage more private capital to flow into this crucial sector. We should also give investors time to better understand the assets they are purchasing, and that is why a statutory cooling-off period in the RMBS market is now being considered.

This is not a partisan problem, and I am encouraged by the bipartisan approach that has been taken in the discussion of this topic thus far. I hope that this will continue as the proposal moves forward and will carry over to other areas.

I want to thank Chairman Garrett and Ranking Member Waters for their leadership on this issue and for holding this hearing in New York City.

I thank the witnesses for being here today, and I look forward to hearing their testimony.

I yield back. Thank you.

Chairman GARRETT. Thank you.

The gentleman from Texas?

Mr. NEUGEBAUER. Thank you, Chairman Garrett, for calling this hearing.

As we are looking at how we get America back going again, I think getting a robust housing finance market operating again is an important part of that.

And I think it is kind of interesting when we hear people talk about getting the private sector back, private mortgage activity back going again, private securitization, as if that is a new concept. And it is not a new concept. We have had private securitization. We have had private market activity throughout the history of the mortgage industry in this country.

What we do have, though, is we have an entity or a group of entities that are crowding out the ability for there to be a robust private market. And as long as you can sanitize those mortgages using the American taxpayers as the backstop, there is very little incentive for private activity, particularly in the subjumbo market.

And so, one of the things that I hope that we will discuss today are ways for us to create some space for the private sector. The Administration has talked a lot about that. Secretary Geithner put out a White Paper, and some of us found some of the concepts in that paper to be something upon which we could agree.

Unfortunately, this Administration has not acted on any of the recommendations that it initially made. And so, Fannie and Freddie continue to dominate the mortgage market in this country. As I think the chairman pointed out, about 95 percent of the mortgage origination today is either FHA-, Fannie-, or Freddie-guaranteed.

The other thing that I think people talk about is what is Congress going to do about that? Obviously, Congress has not been able to move any major reform for Freddie and Fannie, but does Congress necessarily need to do that?

These entities have their own legal right to reduce, for example, the size of loans that they will purchase. The FHFA—Mr. DeMarco has some broad powers as the conservator of that entity, and one of the things that we have encouraged him to do—and I think they are working slowly on that—is to increase the g-fees, and so there to be some financial incentive for private securitization.

But as long as you can sanitize those loans for a relatively small risk premium, you are not going to see a lot of private mortgage activity. And so, we can talk about standardization and all of those things, and those are great concepts, but until we get a more competitive environment for the private mortgage industry, I don't think we are going to see a lot of movement.

I think as we work on all of these various solutions, we need to understand that as long as there is a monopoly in the marketplace by Freddie and Fannie and FHA, it is going to be extremely difficult to encourage private activity unless we make it a more competitive environment.

So, Mr. Chairman, I appreciate you holding this hearing, and I look forward to hearing from these witnesses.

Chairman GARRETT. And I thank you.

Again, I welcome our full panel here, welcome your testimony we are about to hear. Your full statements will be made a part of the record. You each will be recognized for 5 minutes, and I guess we are going to be a little more liberal with that than we normally would be back in the hearing room.

We will begin with the managing director of Barclays Banks. Ajay?

STATEMENT OF AJAY RAJADHYAKSHA, MANAGING DIRECTOR, BARCLAYS CAPITAL

Mr. RAJADHYAKSHA. Chairman Garrett and members of the subcommittee, I thank you for your time.

I am Ajay Rajadhyaksha, in U.S. fixed-income research at Barclays Capital in New York, including research on housing finance and the mortgage markets.

As the members have said, as Chairman Garrett has said, the state of housing finance in the United States, where the GSEs account for over 90 percent of all mortgage loans currently made, is problematic. We think there are several ways in which the government can help change this to encourage private sector issuance of mortgages.

And what I am going to do is break these proposals into three areas. The first is about how to incentivize issuers and underwriters of private label MBS. The second is about making life easier for investors who will be called upon to buy these in the primary and secondary markets. And the third pertains to establishing a benchmark to help the private sector price mortgage credit.

On the issuance front, there are three specifications to address. One is to rationalize various regulatory regimes related to capital requirements. For example, the U.S. banking system, still very regulated, still follow a ratings-based approach. Meanwhile, the insurance industry has moved to loss-based models. In general, we are in favor of loss-based models, as opposed to the "black box" ratings approach.

On that same front, reducing areas of legal uncertainty with regard to rep and warranty, representation and warranty enforcement mechanisms, is also important.

And finally, clarifying the rules around risk retention and disclosures to reduce regulatory uncertainty would go a long way toward making issuers more involved in this market.

On the investor side, there are a few other things to consider also. The first is that from the investor standpoint, we do need a transparent way to enforce reps and warranties. In the private label transactions in particular, as opposed to in the agency mortgage markets, in several cases, investors have had a hard time even getting access to the loan files unless they own more than a majority of the deal.

We would like MERS, the Mortgage Electronic Registration System, to be legalized, and the legal process required to correctly transfer loans will be streamlined from current levels.

And finally, a number of members also mentioned uncertainty around servicing. We can reduce this, we believe, from the policymakers' standpoint, by creating servicing standards that are similar to those required by FHA and FHFA.

Taken together, the first and second steps, I believe, will go a long way to reducing legal uncertainty and providing greater transparency to both investors and issuers. But we are not convinced that this by itself is enough to jumpstart private label mortgage issuance.

Policymakers also need to make an effort to replicate the standardization and uniformity provided by the agency MBS market in one more way—by providing a benchmark that helps the private sector price mortgage credit. What I mean by this is that for decades, the GSEs—Fannie Mae and Freddie Mac—have actively hedged their interest rate risk in the capital markets. But as we now know, to the detriment of the taxpayer, their bigger exposure always has been the credit risk in the mortgages that they guarantee.

We recommend that the GSEs sell a portion of the credit risk in their existing guarantee business to the private sector. I will not go into the exact details in the interest of time, but I will say that we believe implementing this process should be relatively easy. The GSEs have the financial technology to do it. They have done similar one-off deals in the past. It does not require additional congressional action. It does not require legislative action.

Selling credit risk to the private sector would also transfer some of this risk from the taxpayer to the private sector. But again, the single most important reason to do this, we believe, is to establish a benchmark against which the private sector can price mortgage credit.

So what do I mean by that? Consider the loans from 2009 that Fannie Mae and Freddie Mac have guaranteed in the 4.5 percent coupon. There are more than $300 billion of these loans, and they have been outstanding for more than 2 years. That is a lot of data that is available. There is a lot of uniformity around these loans that is available.

This big cohort with so much uniformity, if the GSEs were to sell part of the credit risk in this pool to the private sector, what we think it would do is create a considerably more active market for private mortgage credit. The uniformity, the size of the cohort, and the available data for more than 2 years as far as credit performance goes, all of that means private sector investors will have a benchmark against which to price new deals as they come to the market.

Such a benchmark—and it exists in other markets also—for example, in the agency debt markets, the swaps market, one of the reasons why we believe it took off is because agency debt created a benchmark for that market—is very important for an active secondary market. In this case, an active secondary market for mortgage credit. And an active secondary market, as any participant will tell you, is extremely important for a primary market for mortgage credit.

Finally, and my last point, while I do believe that the private label mortgage market needs to be responsible for a greater share of origination, I would caution policymakers along the lines of the argument Chairman Garrett made to closely watch the pace of any such transition. The availability of mortgage credit is extremely important to the housing market, especially in its current stage.

I look back to the first half of 2007. The unemployment rate was at 5 percent when home prices started falling. It was not because we collectively threw up our hands and decided that housing was clearly too expensive. The reason that happened was because at that point, the availability of mortgage credit came in large part from the nonagency markets. And as primaries shut down, the housing market started to tumble.

So any transition we believe should happen, but the pace we hope policymakers will watch very closely. In the near term, I think the government will need to provide support to housing finance even as it slowly withdraws away from that market.

Chairman Garrett, members of the subcommittee, I thank you for your time and attention.

[The prepared statement of Mr. Rajadhyaksha can be found on page 70 of the appendix.]

Chairman GARRETT. Thank you.

Mr. Hughes, from Redwood Trust?

STATEMENT OF MARTIN S. HUGHES, PRESIDENT AND CEO, REDWOOD TRUST, INC.

Mr. HUGHES. Chairman Garrett, members of the subcommittee, good morning.

I am Marty Hughes, CEO of Redwood Trust, and I sincerely appreciate the opportunity to testify here today.

Redwood has a long history as an issuer and an investor in private prime mortgage-backed securities. Since the market freeze 3 years ago, we have done only two transactions, fully private, backed by new issue mortgages. We are expecting to do a third transaction shortly and would hope to do a fourth by years end.

My written testimony details specific recommendations on Dodd-Frank and rating agencies. I thought with my oral testimony today, I think it is best with a difficult problem that sometimes it is easier to elevate the view and look at the markets, the private label markets in context of what any thriving, healthy market requires.

The underpinnings of those markets are willing buyers and willing sellers. That is what makes it work.

The buyers on the private label side are major financial institutions—insurance companies, banks, and money managers. These investors today are awash with liquidity, looking for safe, attractive yield. With the 10-year at 2 percent, these investors have the capacity to greatly reduce the government's burden that it is taking in the mortgage arena.

I believe a vast pool of these investors will come back and buy AAA mortgages backed by prime loans with two criteria. First, they are going to need a modest premium over comparable agency securities. Again, I think it is modest, perhaps 50 basis points. And in comparison to historical standards, the historical standard of 25, which was in place for 15 years, was where the difference between the two different securities traded.

Second and most importantly, they need to have trust and confidence in the safety of the underlying securities. In completing the two transactions that we did, we worked really closely with AAA investors to win their trust and to meet their demands, and their demands are pretty straightforward: They want fully documented, plain vanilla mortgages that borrowers can clearly repay; downpayments that are real and meaningful; servicers that are competent and trustworthy agents of investors' safe and simple securitization structures; strong and enforceable representations and warranties; and transparency in disclosures and alignment of interests.

In my opinion, the one gaping hole to restoring investors' confidence is the unresolved threat from second mortgages. It was a significant factor contributing to the mortgage and housing crisis. And the first and most important level of skin in the game is at the borrower level. If the borrower can effectively withdraw their skin in the game through a second mortgage, the risk on default on the first goes up significantly.

So now, if we were to switch gears from willing buyers to willing sellers, the sellers in this instance are mortgage originators, which are dominated by the major banks. Under the current paradigm, there is little need for these banks to sell their mortgages through private securitization. Why? They can sell 95 percent into an attractive, subsidized government program, and they have excess balance sheet capacity to easily portfolio the rest.

There is simply no financial incentive for banks to change the status quo. Necessity is the mother of invention. When you need to figure things out, you figure things out.

Post-crisis, all of the other ABS markets are up and running. When you look at how they recovered, it is pretty simple: Success breeds success. Issuance velocity leads to more issuance velocity. There are simply too few loans outside the government's reach to gain any real issuance velocity. Government subsidies need to be scaled back and loan limits reduced on a safe and measured pace to level the playing field and to permit the private markets to flourish.

I would echo the chairman's comments that we need to begin a process of testing the private market's ability to step in the breach. Otherwise, we are always going to be stuck in the circular conversation of, the government can't back out because the private sector isn't there, and the private sector isn't there because the government is stifling and crowding out the private sector.

The perfect test is 3 weeks away. It is when the conforming loan limit is scheduled—the high-cost loan limit is scheduled to come down from $729,750 to $625,500. It represents 2 to 3 percent of total originations, and contrary to what many status quo advocates had been forecasting, there is a smooth transition under way today towards that lower loan limit. Jumbo loans above $625,500 are being offered today for closing after September 30th at only 25 basis points higher to where they were prior to that date.

In closing, the private markets worked effectively for years. I really don't think it is that hard to figure out how to get them back on track. We can go back to when losses were 10 to 25 basis points on prime securities.

So, at Redwood, a small team, we are driven. We have a lot of passion for doing this. We can figure it out. I think with the help of this subcommittee, we need to keep pushing it along, advancing structural policy changes to bring about the redevelopments on the markets on a broader scale.

Thank you for giving me the opportunity to testify here today.

[The prepared statement of Mr. Hughes can be found on page 42 of the appendix.]

Chairman GARRETT. Thanks a lot. I appreciate that.

From Graham Fisher, Josh Rosner.

STATEMENT OF JOSHUA ROSNER, MANAGING DIRECTOR, GRAHAM FISHER & COMPANY

Mr. ROSNER. Thank you, Chairman Garrett, and members of the subcommittee, for inviting me to testify on this important issue.

Between 1989 and today, securitization markets and, therefore, capital markets replaced banks as the lead funding mechanism for home mortgages. It is true that excessive social engineering to overstimulate housing purchase drove speculation. But in my view, poorly developed and opaque securitization markets drove excess liquidity and irresponsible lending and borrowing.

Without the confluence of these issues, we would not have had the withdrawal of liquidity to the mortgage finance market and an ongoing cycle of falling housing prices. Today, as it was in the prelude to the crisis, securitization markets operate in a "wild west" environment, where rules are more opaque than clear, standards vary, and useful and timely disclosures of the performance of loan-level collateral is hard to come by.

Asymmetry of information between buyer and seller is the standard. To believe that the real estate market or the economy itself can find a self-sustaining recovery without first repairing this important tool of financial intermediation is unrealistic. Nothing has been done to create industry standards or useful and timely disclosures of loan-level collateral characteristics.

The primary market for securitizations had been different from the equity markets. There was no red herring or pre-issuance road show period during which investors had the ability to analyze a deal and its underlying collateral.

Typically, deals came to market so quickly that investors were forced to rely on rating agency pre-issuance circulars, term sheets, or weighted average collateral data. These tools have proven inadequate. Moreover, with a lack of pre-issuance collateral disclosure standards, deals usually came to market before the collateral pool was even complete.

While this approach worked well in the TBA market, that was a direct result of clear underwriting guidelines, credit boxes, and servicing standards. Such standards do not exist today outside of the agency market.

To ensure adequate transparency in the non-TBA market, data on specific underlying collateral in each pool should be made available for a reasonable period before a deal is sold and brought to market. Such a requirement would enhance investor due diligence, foster the development of independent analytical data providers, and reduce reliance on rating agencies.

The automation, standardization, and public disclosure of key collateral information before securitization is marketed and at least monthly thereafter is a necessary ingredient to the development of deep and broad markets necessary to fund our economy.

Pooling and servicing agreements and representation and warranties can be several hundred pages long. They define features like the rights to put back loans that had underwriting flaws, the responsibilities of servicers and trustees, and the relationship between the different tranches.

We need to address the lack of uniformity in contractual obligations between various parties to a securitization. Key terms that define contractual obligations are not standardized across the industry, across issuers of securities, or even within the same type of collateral by particular issuers.

The lack of standardization and length of documentation contributed directly to problems in the securitization market. When panic set in and investors began to question the value of their securities, they knew they didn't have time to read all of the different several-hundred-page deal agreements. This reinforced the rush to liquidate positions and supported a run on the market that caused securities values to fall further than fundamentals justified.

With the best interest of the investing public and clarity of contract at their core, legislation should direct regulators to create a single standard pooling and servicing agreement governing each collateral class, whether the issued securities are registered, over-the-counter, or bespoke.

Why standards matter: Legislative and regulatory standard setters must also focus on addressing a lack of clear definition in securitization markets. Without a common language and agreement on the meanings of fundamental concepts, the value of data is diminished. Conversely, if everybody is using a common language, it becomes very hard to game the system.

Amazingly, 3 years after the crisis, there is still no single standard, accounting or legal, of delinquency or default. Currently, the term "delinquency" can be determined either on a contractual or recency of payment basis. Even among firms that would define it on the same basis, each servicing agreement can have different interpretations of the reporting of delinquencies.

While the conflicts inherent in the public-private corporate structure of Fannie and Freddie caused great and significant distortions in the market and led to their ultimate failure, there are really valuable lessons the GSEs demonstrate.

Investors can and will support a TBA market comprised of standardized securities, composed of clearly defined collateral as long as there are adequate clear requirements and standards defining credit, documentation, pooling, servicing, representations, and warranties. Going forward in an absence of a government guarantee, that TBA market would require a gatekeeper to oversee an audit compliance with such standards.

Collateral servicing: When a pool of first lien mortgages is created and sold into a trust, a servicer is chosen to service the loans, collect the mortgage payments, and direct the cash flows to investors as defined by agreement. While investors in different tranches to the securitization may not always have aligned interests, in light of the significant number of mortgages today that have negative equity, most of the remaining holders would be willing to write down the principal balance of the loan if it would result in re-performance of collateral, and this would be driven by private agreement.

Unfortunately, due to an ill-defined legal relationship between servicer and investor, along with a large common conflict of interest between servicer and affiliated companies that own most of the servicers, many servicers do not prefer this “less is better than nothing” approach. The largest servicers are owned by large banks, banks that hold the majority of second liens and home equity lines on the underwater houses.

Remember, the second lien is, by definition, subordinated to the first. So if the servicer wrote down the principal on the first lien, it would, where the mortgage is in a significant negative equity position, completely wipe out the value of the second lien and cause the bank to experience a total loss on that loan.

As a result of an unclear duty of servicers, both investors and troubled borrowers are held hostage to servicing practices that may seek to protect often under-reserved banks rather than the investors in the securities.

New rules in securitization should clearly define the servicer’s obligations and require a fiduciary duty to the investors in securitized pools. Perhaps more effectively, legislation should specifically prohibit financial entities from owning servicing where the servicing results in a conflict.

Four years after the crisis began, we still haven’t begun to have real discussions about either housing policy or the re-creation of the mortgage finance industry. These are two different subjects. To reduce the temptation of legislators to use private markets as tools of social policy, the structure of the mortgage finance industry must be separated from housing goals.

We should be seeking ways to credibly shift financial sector risk back to the private sector, not ways to formalize the government exposure to that risk. The hope is the original promise of securitization through which banks could originate quality loans and sell them to investors who would be better able to hold the risk of those assets can be realized. This would free up bank balance sheets to make more loans in support of financial intermediation and economic expansion.

Thank you for inviting me.

[The prepared statement of Mr. Rosner can be found on page 74 of the appendix.]

Chairman GARRETT. Thank you.

And last, but not least, Mr. Lieberman. Thank you for joining us.

STATEMENT OF JONATHAN LIEBERMAN, ANGELO, GORDON & COMPANY, ON BEHALF OF THE ASSOCIATION OF MORTGAGE INVESTORS (AMI)

Mr. LIEBERMAN. Thank you, Chairman Garrett, and distinguished members of the subcommittee.

Thank you for the opportunity to present on behalf of the Association of Mortgage Investors, to testify and comment on this critically important topic.

I am head of Angelo Gordon's residential debt business, the CIO of our REIT, aging mortgage investment trust, which went public about 6 weeks ago, and also the portfolio manager for the public-private investment partnership with the U.S. Treasury.

The U.S. mortgage market is truly an awesome market. It is $11 trillion. It has the deepest, most diverse investor base in all of fixed income. It has the most liquidity, and it has been historically capable of financing all housing finance in the United States.

Historically, it was built upon three legs of a stool. Those three legs were bank balance sheets—community banks, big institutional banks that portfolioed mortgages; as well as insurance companies, U.S. Government-backed mortgages as well—Fannie, Freddie, FHA, Federal Home Loan Bank; and then, finally, private investor capital, predominantly in the form of securitized product.

Unfortunately, certainly one of the major legs of the market has basically been shut down. Basically, private investors have been very, very significantly punished in the current downturn, have been very, very disappointed about how the market has conducted itself over the past several years. And as a result, it is completely shut at this point, other than a few deals.

There are two major consequences to this. First, it affects our overall access to capital from main street. The diversity of financing available to consumers is dramatically diminished. It creates systemic risk, if anything, even more so than previously existed in the marketplace.

Opportunities for credit are becoming vastly more expensive. And the choices that are available to our citizens are vastly reduced.

With respect to AMI, we have become, we believe, the primary trade association representing private mortgage investors. Our members do not control servicers. We do not foreclose on borrowers. We simply seek to earn a return on investment in the securities or the mortgages.

For most of our members, all that we are seeking to retrieve is basically a Treasury return, plus a small premium to Treasuries. We are not seeking oversized returns for the vast majority of our membership. It could be as simple as Treasuries plus 50 basis points or 100 basis points, not excessive returns, not equity-oriented returns for the vast majority of our members.

The association has members that basically have investors that are your life insurance companies, your State pension funds, your local retirements systems, your endowments, your retirement systems, your 401(k)s, your mutual funds. We have sought to develop a set of priorities that we believe will contribute to the rebirth of the marketplace. AMI has come together to basically identify obstacles and try to identify solutions that we believe can be implemented by folks like yourself.

In summary, the current mortgage investors have basically suffered from a number of problems in the securitization space. The market is very opaque, asymmetric in terms of information flow, and thoroughly lacking in transparency.

Underwriting standards are basically nonexistent to poor. There has been a lack of standardization and uniformity concerning transaction documents, delinquency, default status, advancing status, true sales status, and the list goes on. There are numerous conflicts of interest among all of the parties and even the regulators.

So, in terms of conflicts of interest, many servicers are conflicted that they have outsourced to their own entities different third-party activity, whether it is property appraisals, whether it is title, whether it is flood insurance, whether it is foreclosure management—all of which basically results in skimming of equity from the property, from the borrower as well as from investors as well as from the U.S. Government.

Originators and issuers are not honoring their contractual representations that they sold into the securitizations. The past is a prologue, and there are serious assurances that this will not be repeated in the same bait-and-switch scenario as we have seen.

The market is generally lacking in sufficient tools to protect first lien holders, such as recourse to the homeowner to avoid strategic defaults, and efficient ways to basically manage second liens to allow the borrower to work out their loan and stay in their house, as well as protecting first lien holders.

Servicing practices are antiquated, defective, and generally unreliable. Information flow is unreliable to investors. Oftentimes, we cannot reconcile cash that is coming into us. Oftentimes, servicers come back and 2 years later seek capital back from us because they have made some error in the servicing process or reporting process.

Investors lack any sort of effective legal remedies for violations of RMBS contract obligations or other rights arising under State and Federal law.

The development of enhanced structures, standards, safeguards will all contribute to the proper functioning of capital markets, the proper allocation of capital, the proper pricing of capital, and ultimately, a more successful main street that we believe in. Mortgage investors share your frustration with the slow restoration of the housing market, relief for homeowners, and finally, the redevelopment of capital markets in a meaningful way.

We believe that the recommendations that we lay out will help in developing the market once again in a safe and competent fashion and incentivize the right positive economic behavior.

In sum, AMI offers the following recommendations for enhanced transparency and as an alternative to risk retention within the capital markets.

We believe that we should be provided with loan-level information that all investors, as well as regulators, as well as rating agencies can use to evaluate collateral in an open and thorough manner for making our investment decision and continuing to monitor our investment decision. With Fannie, Freddie, and FHA controlling 95 percent of the market, you would think at this point in time, they would release the data necessary for us to do so and conduct that evaluation.

We would require a cooling-off period where asset-backed securities are offered, where investors have sufficient time to review and analyze loan-level information before making investment decisions. We wouldn't expect the investment to be put together after we purchased the asset.

Make deal documents for all asset-backed securities and structured finance securities publicly available to market participants and regulators in a sufficient manner where we can basically analyze and comment on them in advance.

Develop for each asset class standard pooling and servicing agreements with model representations and warranties as nonwaiverable industry minimum standards. To kind of make this common sense, currently, we have situations where the definition of a dollar doesn't mean 100 pennies. Everybody in our market has a slightly different definition of what a dollar is, what a pound is, what an ounce is. It is very hard as an investor to basically navigate in a market where basically a dollar doesn't mean a dollar.

Develop clear standards for the securitization market and the capital markets. Direct address conflicts of interest for the servicers and try to basically remediate economic incentives that are adverse to investors as well as homeowners. Once again, we should all be on the same page that we are just getting our Treasury plus yield.

Homeowners, we want you to stay in the house. Nobody is interested in owning a lot of real estate. That is not our objective to own these securities.

And come up with a thorough way to restructure, modify, and work out these assets in advance that all parties are in agreement on. Inevitably, there will be personal events, crises, because we are human beings, and we should have a game plan in place to basically try to modify these loans or basically do the correct thing in terms of processing the collateral so that we can continue to offer low interest rates.

Just as the Trust Indenture Act of 1939 requires the appointment of suitable independent and qualified trustees to act on behalf of holders of corporate debt securities, model securitization documents must contain substantive provisions to protect asset-backed security holders as well.

Asset-backed securities should be explicitly made subject to private rights of action for fraud and securities disclosure violations. Certain asset-backed securities can be simplified and standardized. Fannie and Freddie should be working to help achieve that.

And rating agencies need to use loan-level data and basically make their assumptions known in an organized manner to all investors if they are going to continue to be a central part of the securitization process. We believe all of these recommendations will result in more home lending, less expensive credit, fewer housing foreclosures, and more options for working-class Americans.

We hope that this is helpful, and we appreciate the opportunity to share the views of the Association of Mortgage Investors with the subcommittee, and please do not hesitate to use us as a resource.

[The prepared statement of Mr. Lieberman can be found on page 59 of the appendix.]

Chairman GARRETT. And I thank you for your testimony.

I see we are joined by the gentlelady from New York, Ms. Hayworth. It is good to have you with us. Good morning.

We will begin the questions, and I will do my best to keep it down to 5 minutes, as we have a number of people here.

Just to Mr. Lieberman's comment with regard to the definition of a dollar, a lot of us realize the dollar is not just worth what it used to be after all the spending down in Washington right now. So that may be an issue that we have to take up. And we will have the answer on that one Thursday, I think, after we hear from the Administration.

So taking this all from, what, a 30,000-foot level and then bringing it down into the weeds a little bit, there seems to be some commonality on the issues of where we were, the problems that we experienced, and at least some of the solutions on where we need to get to. There seems to be some sort of a degree of common thought with regard to not having to the extent that we have had in the past with regard to government backstop and to move towards greater capital infusion from the private sector—all good.

One of the statements I will direct to Mr. Hughes, and anybody else can join in on these questions. So one of the questions going on, on the top level is, so is there a problem with, as some people say, that there is a lack of—maybe Mr. Lieberman could chime in on this—investor demand on the one hand, or is it actually an issue of lack of supply on the other hand?

Or maybe it is—from the testimony, maybe it is a mixture? Mr. Hughes?

Mr. HUGHES. I do think investors—and again, issuers have to meet all of the investor's criteria for trust and confidence—are awash with money looking for investments today. I think the bigger issue is there is very little to buy, and you can't gain any traction if there is nothing to even buy.

And you can't gain traction on all the best practices that we are talking about. You can't gain traction on reps, warranties. What is the best way to do it? We put two deals out there and let people shoot at them, and if we got something wrong or we can improve it, we will improve it.

But the only way you can get there is by having a deal flow. And we are not going to get there if there are really no loans to securitize.

Chairman GARRETT. What is the reason for that?

Mr. HUGHES. The government is crowding out the private sector.

Chairman GARRETT. Thank you.

Mr. Rosner, you were shaking your head?

Mr. ROSNER. No, I was going to agree that it is a process of one crowding out. The other side is we had overstimulated homeownership, which is another reality that we need to consider, which is homeownership rates, having gone from 64.5 percent in the early 1990s to just over 69.5 percent, have fallen back.

There isn't the fundamental demand at this point, partially because there isn't the confidence that we have stabilized housing. And so, it becomes a virtuous circle that at the point at which we are able to bring confidence that housing has started to bottom, maybe we will start seeing increase in homeownership.

I do fear that when you look at the homeownership rates by age cohort, they are falling considerably in every grade except for really the retirement age. And you wonder how much of that is, unfortunately, a permanent impact of the realization that maybe homeownership is not always the right answer for every household.

Mr. LIEBERMAN. Chiming in, I guess we seem to do pretty well in the credit card market and the auto market, providing private capital to individuals, Americans, at very attractive levels. You can go into pretty much any auto dealership, and they have 24 different lenders that will lend you money at 1, 2, or 3 percent or zero percent, pretty much.

We have, I think, significant private capital that is looking for attractive investments. But when you are competing with either the world's largest S&L or the world's largest REIT that is financed with the cheapest cost of capital and has basically total access and control over 95 percent of the market, you take a step back and realize that predominantly you are going to be adversely selected.

So we might as well wait until the rules are set and we understand what the real rules are for the process. And maybe some of the piping, which still has not really been addressed—

Chairman GARRETT. Right. Let me be the devil's advocate on that point. So much of this testimony that we have heard here today is that we need some degree of uniformity on these areas, some clarifications and all. We will probably all go into each one individually, but do you have that in all these other marketplaces, the same degree of uniformity and government definitional aspects within all those other marketplaces there to the same extent that you would have here, that you would look for here?

Mr. LIEBERMAN. You have much greater uniformity. In the credit card market, you really only have 6 to 10 parties that issue credit card securitizations, and they are typically—

Chairman GARRETT. But the uniformity doesn't come about necessarily because of regulations that we have defined and as far as servicing agreements and all that sort of thing, right? It comes because of the nature of that marketplace.

Mr. LIEBERMAN. The issuers there have taken a great deal of responsibility, have built very robust programs and have also retained a great deal of risk in the programs. So if you buy an American Express securitization, you know you are going to get a dollar back, and you know—

Chairman GARRETT. Why can't we do that or why can't you all do that in this area? Mr. Rosner, you mentioned during your testimony that in some aspects of this, it is taken care of contractually. Mr. Hughes might want to join in on this as well.

In your couple of situations, you said here is what we are going to do, and again, devil's advocate, why can't we just do this, going forward, maybe incrementally small at first, and just grow the market from that perspective?

Mr. HUGHES. I don't see any reason why it can't grow on that basis.

Chairman GARRETT. Okay.

Mr. HUGHES. One thing that I—

Chairman GARRETT. So you don't need—so you disagree? You don't need the extent—

Mr. HUGHES. You do need standardization.

Chairman GARRETT. Okay.

Mr. HUGHES. You need some, but it needs to develop over time. If we sit back and wait for the perfect legislation, the perfect process, we will be back here 3 years from now. The way processes and best practices are going to develop is by testing them.

Chairman GARRETT. Okay.

Mr. HUGHES. The second thing I would note is—and I am glad for this subcommittee—some omnibus oversight of all the initiatives that are going on. You have stuff under legislative. You have Dodd-Frank. You have some stuff that has to happen under the securities law, under Reg. AB. You could have Garn-St. Germain.

There is an assortment—best servicers, best practices. So it is great to have a subcommittee of this type where somebody has a to-do list to figure it out so that all the links in the chain are pulling ahead, so that we don't—not working on one while someone else is going to hold things back.

Chairman GARRETT. Sure.

Mr. ROSNER. I was just going to point out there are some obvious differences, though, between auto securitizations and credit card securitizations versus mortgage securitizations in terms of duration. And there are, by the way, increased disclosures in static pool data in those other markets that you don't get in the MBS market.

So I think that standardization is somewhat easier, given the turnover in the underlying collateral.

Chairman GARRETT. Okay.

Mr. LIEBERMAN. I would just add that I think that the private sector, in order to compete with the public sector, resorted to certain shortcuts. The way you basically compete with somebody with the lowest cost of capital and the best access to product is you basically change the definition of what a dollar is.

You change the rules of the game. You create opaque markets. Otherwise, if it is standardized, people understand. They are just going to migrate to "the best product out there," which is no risk and—

Chairman GARRETT. Right. So this will be my last question, and then I will turn it over to the other side of the aisle.

One of the areas you will address—and I am sure other will people want to delve into this and go in more detail—is on first and second lien situations, that can't be done just—it could be, but not adequately with regard to a contractual obligation, based on this last series of answers. So what is each one of your answers to that solution, question?

Mr. HUGHES. To me, I think there needs to be some limitation on the ability to take out a second mortgage. It could be a mathematical test of the loan-to-value can't go above 80 percent. In no other form of lending, whether it is in commercial loans, corporate loans, can the borrower go out, take out a primary loan and then go out and be able to impair their credit condition by taking out a second loan. The first is going to say "stop."

But there is no governor on here, and I think the governor could be some formula-based, based on a reappraisal. And I would say it would have three benefits. In addition to protecting the first, it would have the benefit of protecting the financial system from banks offering something they shouldn't and it can protect the borrower from taking and putting themselves in the position where they shouldn't be in terms of putting themselves in credit peril.

Mr. LIEBERMAN. I would say that in Texas, they had an experience where they had an oil bust, and it led to a housing bust. And I think the response there is they prohibited second liens for a long period of time.

One of the reasons the Texas housing market has held up better than any other market in the United States, not only because of job growth, is also because they truly had equity in their houses. That law was subsequently changed and modified in the last 3 years. But still, it was one of the best housing markets where if a borrower really wanted additional equity, they had to go refinance their entire first mortgage and could not put a second lien there.

Chairman GARRETT. Ms. Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Lieberman, what is your take regarding voluntary cramdown?

Mr. LIEBERMAN. I think we would like to see Bankruptcy Code changes that basically elevate the first mortgage on a house and allow us to price the credit effectively. And if that involves cramming down second liens and other obligations, we believe that if society, government, and the homeowner wishes to have a very low cost of funds on their first mortgage, that is something they should think about.

But it is a judgment call. And if the corporation wants first lien debt and wants a very cheap cost of funds, their lien has priority over all others, and there can still be cramdown there.

Ms. VELAZQUEZ. Does your organization come out with any position on this area?

Mr. LIEBERMAN. We have not formally come out with a position.

Ms. VELAZQUEZ. Mr. Hughes, mortgage originators and securitizers are currently facing numerous lawsuits for the mortgage-backed securities that were issued prior to the financial downturn. Are these developments keeping potential investors from reentering the market for mortgage-backed securities?

Mr. HUGHES. I don't think it is the lawsuits themselves. But the underpinning of those lawsuits, which were faulty representations and warranties where the reps and warranties which underpin these securitizations really failed on three levels. First, the actual representations and warranties themselves had little teeth. The second one was they were unenforceable. So, there was no traffic cop that could actually take it and determine whether there was a legitimate issue. And the third was, in many cases, they weren't collectible.

So, on all three levels, it failed. And in our deal, on the underpinnings of the past, we changed all three levels of the representations and warranties to give them teeth. We tried to get the model representations and warranties. We wouldn't buy loans from anybody unless they are willing to submit to binding arbitration if something goes wrong.

But, yes, I think it is the underpinnings of those lawsuits that really have investors alarmed.

Ms. VELAZQUEZ. Mr. Lieberman, do you have any reaction to this question?

Mr. LIEBERMAN. I think I would have to get back to you on that. Just a clarification on cramdown: The organization, the Association of Mortgage Investors, believes in the priority of a first lien under all circumstances. Second liens, we believe, if there is no equity in the house, should be wiped out to allow for the first lien to be protected.

Ms. VELAZQUEZ. But on the question of the lawsuits that have been brought up against mortgage originators and securitizers, do you believe that they have any effect in keeping investors from re-entering the market?

Mr. LIEBERMAN. I think the underpinnings, to Mr. Hughes's point—if we can't enforce rep and warranty violations and we cannot be certain about contractual rights that we have, representations on the quality of the merchandise that we are buying cannot be protected, we just—investors, like a taxpayer, need to be protected, and that will affect our decisions.

As I said, we have to know what the rules of the game are, and we have to be protected under those rules. Otherwise, we will take our capital and invest in other markets where we know what the rules are and we know what the return is.

I come back to, we are really not seeking oversized returns. We are not trying to be equity investors. That is for others.

Ms. VELAZQUEZ. Understood. Thank you.

Mr. Ajay, I will not dare to pronounce your last name. Sorry.

But given the failure of rating agencies to perform sufficient due diligence in the review of private label securities prior to the financial crisis, what role, if any, do you think the credit rating agencies should play in this market, going forward?

Mr. RAJADHYAKSHA. Thank you for the question.

We are in favor of industries in general moving towards the approach that the insurance industry has taken, where what they have done is for individual asset classes, they have decided that specific loss-based models—in one case by PIMCO, in another case by Blackrock—will be the model space on which capital standards will be generated.

For obvious reasons, I think ratings on securitized products have been found wanting, and at this point, given the last several years, many investors that we talk to prefer to do their own due diligence, as opposed to buying an asset because of a rating.

Ms. VELAZQUEZ. Do you believe that the credit rating agency reforms included in the Dodd-Frank will be sufficient to restore confidence in the use of credit ratings?

Mr. RAJADHYAKSHA. I am not sure, to be very honest.

Ms. VELAZQUEZ. I expected that answer.

Recent settlement proposals between leading mortgage servicers and private MBS investors have focused largely on chain of title provenance and the effort to define who should have the right to foreclose on troubled mortgages. Is it reasonable to believe that these parties can adequately resolve these issues between themselves without the need for government intervention?

Mr. RAJADHYAKSHA. That will depend, I suspect, in many cases on a case-by-case basis. But I will say this. For a securitized market, that is in many ways a very good thing for the U.S. homeowner, because you basically have a market which is attracting capital from the rest of the world to lend to the U.S. homeowner at the lowest possible rate.

The actual process, the plumbing, in many cases is archaic. So what we would like is for policymakers to set specific rules that are clear and then let the capital markets have their way.

Ms. VELAZQUEZ. Okay. Thank you.

Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman from Arizona?

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

I am going to try to bounce around quickly, just get into some specifics.

Mr. Hughes, you spoke about the second loan problem, "chewing up the skin in the game," I think was your term. Would it work if the first deed of trust, first mortgage instrument said if you chew up this equity without getting a release or an acceptance from the first, the first now becomes a personal liability? Is that enough?

Mr. HUGHES. Potentially. I think the right answer is to prevent the second loan from coming out in the first place. Because I always think if you leave it to the borrower and allow them to pull equity out, even with penalties, I think that would be bad policy.

Mr. SCHWEIKERT. So you would create sort of a first loan instrument that would—the way however it is recorded and whether it be the MERS world or the county recorders, there would be a document saying, oh, by the way, I also pledge that no secondary instrument is allowed to go behind us?

Mr. HUGHES. Yes. I think that one way to do it, and there are probably a lot of ways to do it is I think you need to—if you get your loan from "XYZ" bank and that is the first, really what you need is to prevent a second bank from extending that mortgage.

And I think really the best place to put the control mechanism in place is if that second bank extends a loan above some criteria, whatever, it is 80 percent of whatever you do, is put it somewhere in truth-in-lending so that they can't foreclose. Put them in a position so that they are not going to extend a mortgage that a borrower can't afford.

Mr. SCHWEIKERT. That is actually a creative idea.

Mr. Lieberman, you have touched on the exact same issue. We have been playing with some language, saying that if you chewed up that equity you had pledged in acquiring your first, that first now became a personal liability. What would you do? How would you deal with that secondary issue, that second loan issue?

Mr. LIEBERMAN. I think, going forward, you either have to prohibit seconds altogether, and the borrower is fully entitled to take out unsecured debt. But not to basically permit, as Mr. Hughes said, that second lien holder from either impeding foreclosure or foreclosing on that borrower.

If you want to have the lowest cost of capital for that first mortgage, which is ultimately what really drives homeownership, then basically protect the first lien and take the second lien holder's ability to seize collateral away. Now you—

Mr. SCHWEIKERT. Mr. Lieberman, I am sorry. I just am trying to be very efficient here. My understanding is, though, if the second is foreclosing—I come from a deed-of-trust State—it has to also still pay off that first. And that is the same in a mortgage State. So what am I not understanding in those mechanics?

Mr. LIEBERMAN. I am just saying that basically, if you are a first mortgage holder, do you want to even get into a situation where there is a foreclosure action going on because of a second? Okay, that is really what I am driving at.

It is hard to, if you try to basically nuance it and try to basically thread that needle so you have seconds that can take out the firsts, then how do you have a situation where the second is underwater and can stop the first, other than the first goes through the foreclosure process and then can't get rid of the second?

Mr. SCHWEIKERT. Okay. Now the second—not to try to be amusing, but the second part of what you just said or in your testimony was now the strategic defaults. I have a first. I am underwater. I am making an economic decision that I am creditworthy enough. I am going to go buy the house down the street. I walk on this one.

What would you do in that situation?

Mr. LIEBERMAN. Okay. I have the first mortgage. Josh has a second mortgage.

Mr. SCHWEIKERT. Poor Josh.

Mr. LIEBERMAN. I am partially underwater. Josh is fully underwater. He won't subordinate. He won't basically give up his second lien. The only choice for the borrower is to strategically default.

Even if I want to compromise with that borrower and shave 10 percent off my mortgage, that is a very untenable situation where I can't create a workout with the borrower, whom I want to keep in the house. I am going to lose another 30 points if I have to foreclose, okay, and then I can get rid of Josh's mortgage. But I am going to lose 30 or 40 points because I am going to have to go through the whole foreclosure process.

It would be much better if Josh basically can't stand in the way. He has a choice: Buy me out at par, or let me modify my loan.

Mr. SCHWEIKERT. That would have to be designed very carefully so as not to create a cascade of where I am now incentivized to fall a handful of payments behind so I can actually participate there.

Mr. LIEBERMAN. That is true. That is the conundrum.

Mr. SCHWEIKERT. Okay.

Mr. ROSNER. You also have to remember that the reality is, yes, the first has to be paid off on a foreclosure attempt. But if you have the servicer of the second tied to an affiliated entity that owns the second, what you will often find is the bleeding of cash flows from the first to protect the second, to protect servicing income, etc.

So you are just trying to string it out as long as you can to maximize your income from the second and from the servicing of the first, knowing that any advances that you are making on the first are also going to bring you to the top of the waterfall, and then you are going to end up taking that back.

So that conflict is, frankly, untenable even where it is designed to work well.

Mr. SCHWEIKERT. I think we are all open to any suggestions on if you were designing a UCC of private label MBS, what mechanics or what triggers you put in there.

Trying to do this quickly, you talked about the TBA, the "to be announced" market. In your vision, how would you deal with that?

Mr. ROSNER. Look, the reason that we have an effective TBA market is Fannie and Freddie created a very clear underwriting box, and they created very clear documentation, rep and warrant, servicing standards. I don't think it is impossible to go from one very large underwriting box to five or six clearly defined underwriting boxes.

Mr. SCHWEIKERT. But would you have to basically create a TBA market that says the only things we will be acquiring—is it a guarantee into a future, if you were trying to put that together right now in a private MBS?

Mr. ROSNER. Yes. I think it would require that there first be the definitions of the collateral that could be put into each of those very clearly. I don't know—at this point, I think you would probably need a transition period of guarantee or some form of guarantee to have any comfort there.

But I think that we should start by putting in place the plumbing to effectively have a private—

Mr. SCHWEIKERT. You and Ajay and this plumbing thing.

[laughter]

Mr. ROSNER. I think I just took it from him because it was—

Mr. SCHWEIKERT. Yes.

Mr. ROSNER. I think, ultimately, we can have a private TBA market. But again, it would require very clear rep and warrants. It would require very clear underwriting boxes. And we haven't seen any effort to do any of that yet.

Mr. SCHWEIKERT. All right. Mr. Chairman, thank you. And I have a few more but will wait, hopefully, for a second round.

Chairman GARRETT. Sure. Absolutely.

The gentlelady from New York has also joined us. Mrs. Maloney?

Mrs. MALONEY. First of all, I would like to thank all the panelists and thank all my colleagues, particularly Chairman Garrett and my colleague Nydia Velazquez, for coming to New York and holding this hearing. It is very important, and I appreciate all the presence here.

And I think we all agree that attracting private pull to capital is critical to a well-functioning securities market and that, done well, mortgage-backed securities are an important source of capital to institutions that allow them to continue to lend and extend credit. So, I am thrilled with the panelists here.

I would like to ask a question, if I could, about covered bonds. I am the lead Democrat on a bill that I have been working on with Chairman Garrett and the other members of the committee for, I think it is 4 years now. And this would create a regulatory structure for a covered bond market.

While I know that covered bonds are not the answer to the entire problem, it is a source of capital. And so, I would like all of you to comment on how you think that they could work to get capital out there like the GSEs did in the housing finance system. And I think that they are an important tool. They are not the complete answer, but an important tool.

And can each of you comment for the record on how you see covered bonds functioning either with or without a government role in the market? That is my question, and if you could just go down the line and comment, your comments would be very helpful to us. We are working on a bill. We have passed it out of the subcommittee and hope to pass it on the Floor.

So, any comments you can give today or put in writing, we would appreciate. Thank you.

Mr. RAJADHYAKSHA. On our side, I should start by saying that we believe that covered bonds are absolutely a viable source of funding, an alternative viable source of funding for the mortgage market in the United States. We have had very good experience. Barclays actually happens to be one of the biggest players in the European covered bond markets, where that market is one of the bigger sources by which mortgages are financed.

For the next several quarters, even if legislation goes through quickly, we suspect that the overall size of that market is probably going to be limited to about $300 billion to $350 billion, which is not small. It definitely doesn't solve all of our funding problems on the mortgage side.

The reason is because, as you know, the FDIC has mandated basically that more than a certain amount of bank value sheets should not have covered bond exposure. So what that basically means is if you make the argument that in the near term, you are only talking about big banks being able to issue covered bonds, then you are talking about maybe a $7 trillion balance sheet. Four percent of that gets you to about $300 billion, which is what I talked about.

The one thing I will say is that the most successful covered bond market is the Pfandbrief market in Germany. It has very, very clear-cut rules. I do not think you need government support. What you do need is a legal framework, a legislative framework. None of that exists in the United States.

Hopefully, the bill that is being proposed takes care of that. If that happens, then we think the covered bond market will start to be not the main solution or a silver bullet, but a viable source of funding for mortgages.

Mrs. MALONEY. Any other comments?

Mr. HUGHES. I would agree with Ajay and his comments, and I don't have a lot to add, as really our focus is on trying to bring back securitization. But I think, certainly, covered bonds could play a viable role in bringing liquidity back to the mortgage markets.

Mrs. MALONEY. Mr. Rosner?

Mr. ROSNER. I think covered bonds have to be considered very carefully in a world of too-big-to-fail institutions. Because I think there is a risk that we are creating incentives for those banks to increase the size of their balance sheet.

Yes, there is an understanding of isolation of those assets. But I fear that debt investors would, nonetheless, increasingly assume that the issuing entity is gaining an even stronger implied government guarantee, much like a GSE on the debt issued by the entity itself.

Mrs. MALONEY. Okay.

Mr. LIEBERMAN. We believe in a hybrid, multi-distribution model for the mortgage market. It is the broadest potential distribution will bring down the cost of capital. Covered bonds are effectively just a form of secured financing, not all that dissimilar from credit card master securitizations.

And so, I think it is just another form of capital for the market. It is one of many, including traditional securitization, that we think is a valuable tool for financing mortgages in the marketplace.

Mrs. MALONEY. Thank you. And any other comments anyone would like to get in the record, I would appreciate.

I believe my time is up, Mr. Chairman, or do I have time for another question?

Chairman GARRETT. Sure. Absolutely.

Mrs. MALONEY. Okay. On securitization, we really have to get that moving again, and I know that was a subject of your testimony. I was at three meetings before I got here. This is a district work period for us, and so we are focused on a lot of things happening here.

Could I just go down the line again, not in great depth, but if you had to name the top one thing we could do to get the securitization working in the markets again, what would it be? What could government do to help the private sector?

Mr. RAJADHYAKSHA. Reduce both legal and regulatory uncertainty, which is stymieing, we believe, both the issuing side as well as the investor base.

Mrs. MALONEY. Thank you.

Mr. HUGHES. Something I didn't mention before is that sometimes when you have a really complex problem, the best way to solve it is to simplify. And I think one of the things we might think about is if we are trying to solve all the problems that were in prime, Alt-A, and subprime, it is really difficult. Bad things happen to all, but really bad things happen in subprime.

Is there a way through the securities laws that you could promote and allow people to use their shelf-registrations for prime loans, to the extent we define prime loans. Similar to what they do if you are going public, depending if the first time, you are an S-1, it takes a really long time to get public. If we could define a certain type of collateral as prime and if it is a down the middle definition of prime, then here is your route to use your shelf registration to securitize it. If your collateral is not prime, if your deal is overly structured, if the collateral is weak, you do what they do with an S-1. You just sit in the penalty box and wait for the SEC to approve it.

So, really, my thoughts around if you really want the prime market back as the best place to alleviate the government's burden, maybe there is a way to subdivide the problem and simplify it around prime and move away from Alt-A and subprime.

Mrs. MALONEY. Mr. Rosner?

Mr. ROSNER. I think to simplify at least what I was saying before, the goal should be to get the borrower and the investor to actually come as close to each other as they can and take out the distortions and the arbitrage of the middle, okay?

Because the reality is the interests of the borrower and the interests of the investor are actually well aligned.

Mrs. MALONEY. What about the servicer? They are often in there. Can you align the servicer with the borrower and the investor? Because oftentimes that is in there in between. They buy it. They own it.

Mr. ROSNER. The servicer, though, often has other conflicts in place, which we went through. And frankly, maintaining fees sometimes protecting affiliates are, frankly, larger incentives.

Mrs. MALONEY. But they are right there in the middle. You can't—

Mr. ROSNER. No, they are in the middle.

Mrs. MALONEY. You can't align the investor and—

Mr. ROSNER. The testimony was really about servicing standards, standardizing reps and warrants, standardizing the issuance of collateral-level information to investors before deals come to market and on a monthly basis after they come to market, and making sure that the ability of the investor to work with the borrower isn't impeded by that servicing relationship.

Mrs. MALONEY. Thank you. That is very helpful.

But on your first question on covered bonds, you said that covered bonds were going to make banks too big and imply a government guarantee. There is no government guarantee on covered bonds. So I didn't quite understand the point you were making—

Mr. ROSNER. No, there is no government guarantee on covered bonds, but the issuing institutions will be growing their balance sheet. Some of the assets will be theoretically isolated, legally isolated through the covered bond. But the market will likely offer a lower rate of issuance on the debt of the institution itself because there is an understanding or an expectation of an implied government guarantee.

I think that has to be something to be thought through and be careful of because we are also creating again a further unleveling of the playing field between our small financial institutions and those handful of largest financial institutions through the covered bond market.

Mrs. MALONEY. And also you know we are no longer too-big-to-fail. We have in place a law that allows us to wind down institutions so that—we just had two choices at one point. You could either bail them out, or they would fail. Neither choice was appropriate. We now have an FDIC approach for the large institutions and to wind down in the event of a problem.

Mr. ROSNER. That only works if you assume that a single large institution can go down in isolation without the correlation of that institution being well related to its peers, in which case you end up with four or five going down at the same time, and I don't believe that Dodd-Frank addresses the ability to deal with that.

Mrs. MALONEY. Thank you very much.

Do you have a comment on securitization?

Mr. LIEBERMAN. Yes. I think confidence that if I am lending yourself money for the next 30 years, that my servicer, my agent will be able to collect that money and foreclose, if need be. And the money that is owed to us as an investor, which is typically a pension fund at the other end, will be respected so that I have the certainty to make the original investment decision to lend you the money.

Mrs. MALONEY. Thank you, panelists, and thank you, Mr. Chairman, for coming to New York. Thank you.

Chairman GARRETT. Thank you.

The gentleman from Texas is recognized.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Mr. Hughes, I know that you all have done a couple of deals. You said you have one maybe coming out quickly, and then maybe another one before the end of the year. Why aren't you doing below jumbo deals?

Mr. HUGHES. Right now, we could not be competitive with Fannie and Freddie pricing.

Mr. NEUGEBAUER. In other words, today, if I had a bunch of loans that met Freddie and Fannie's criteria, you wouldn't be a buyer for them because you can't make any money because you can't—

Mr. HUGHES. Correct. We cannot compete at the moment with their price.

Mr. NEUGEBAUER. If I would take 50 basis points less, offering you 50 basis points more, would there be a market for that?

Mr. HUGHES. I think if you—yes, I think there is a market. If you level the playing field, if you went and looked at the underpinnings of some of the agency securities that are going out now, there are 8 percent have some MI on it. But if you look at the vast majority and you look through the FICO scores, you're at 750, there is 30 percent down on average, these are loans that the private sector, in my opinion, will buy. They look a lot like the loans, if you get the low loan size, in the deals that we did.

So if the borrower is a good borrower, then we just need to clean everything up. Yes, I see no reason why—Redwood Trust is prepared to buy any loan of any size, to the extent that it is a good prime loan. But right now, we can't buy that loan.

Mr. NEUGEBAUER. So if the g-fee was increased to a point where there is a 50 to 60 basis points premium, that if you had well-documented, well-underwritten loans where you could offer the investors another 50 or 60 basis points other than buying the sanitized version which you get are 50 to 60 basis points less yield, you say that there is a market for that?

Mr. HUGHES. I believe there is a market there, yes.

Mr. NEUGEBAUER. Ajay? I will call you Ajay. You can call me Randy. How is that?

[laughter]

Mr. NEUGEBAUER. You mentioned something interesting, and I apologize that I have not had a chance to read the entire version of your written testimony. But what you are talking about is selling about $300 billion worth of the guarantee business that Freddie and Fannie has originated since 2008.

Is that a way to kind of test the market and see if there are entities out there interested in being in that business?

Mr. RAJADHYAKSHA. Yes. What we were talking about was selling what you might call the first loss piece or the credit risk of those $300 billion. So you are really talking about selling maybe $10 billion of actual assets into the market, which is a much more digestible issue for the market.

And there are three or four advantages there. One is, and I go back to the point one of the other panelists made about a healthy secondary market being extremely important for the primary market to pick up.

Mr. NEUGEBAUER. Yes. Because they hold portfolio, they have some loans in a portfolio.

Mr. RAJADHYAKSHA. Right.

Mr. NEUGEBAUER. But you are basically just talking about the guarantee portion now, and somebody would buy that income stream of those guarantee fees that are coming in on a monthly basis?

Mr. RAJADHYAKSHA. That is correct. The goal would be to—if I may take a step back, if you go back to January 2006, Fannie and Freddie, which have been a bigger and bigger share of originations, started to lose market share because the loan agency market was, quite frankly, doing silly things, right?

But Fannie and Freddie, in an effort to maintain market share, followed the loan agency market down the credit spectrum, and that is where the vast majority of their losses come from, loans made in 2006 and 2007.

What we would do is even if Fannie and Freddie ever felt the need to do something like that, they would have to go and then offload that credit risk in the secondary markets. And chances are the market would—the same reason why the market is willing to buy mispriced credit risk in the private markets, they would also be willing to buy credit risk off Fannie and Freddie's books.

Mr. NEUGEBAUER. Yes. I thought it was interesting that you were talking about the more recently underwritten loans. I would think that there would be maybe more interest in the pre-funny stuff. In other words, more seasoned loans where you have repayment history. Obviously, the duration of those that cash flow probably going to be reduced because, what, the average loan life is, what, about 7 or 8, 9 years or something like that. And so, the investor would be buying possibly a shorter cash flow. Is that right?

Mr. RAJADHYAKSHA. Yes. But the problem with loans underwritten by Fannie Mae or Freddie Mac before, say, 2008 is that many of these loans are, quite frankly, very poor credit quality. By contrast, the loans from 2009 are pristine.

So if you want to test the market, if you want to get a secondary market up and running, it is much easier to transfer credit risk from those loans to the private sector.

Mr. NEUGEBAUER. And do you have any reason to believe that there are companies out there, or is this kind of a hypothetical thing, or do you have knowledge that you think there are entities interested in that?

Mr. HUGHES. There are entities that are interested in doing it. And I think, to the extent the thought was if we are going to wait until some co-op gets built or some utility gets built, it could take a very long period of time.

What you could look to are the one-off transactions where the private sector would essentially take the first loss risk and put Fannie and Freddie in a reinsurance position similar to Ginnie

Mae, similar to the multi-family may go a long way. You have to think through preserving the TBA status, but basically de-risking and putting into private sector potentially a company like Redwood actually taking that credit risk.

Mr. NEUGEBAUER. What I was thinking about, and as you all were involved in this conversation, is where are we in the sense that we have the Treasury saying that they will capitalize Freddie and Fannie to whatever level to meet their obligations?

Do you believe legally that, in other words, if I bought these securitizations in the last 2 years, I bought that based on the assumption I am actually buying sovereign debt because I have the United States Treasury behind the entity that is—so if I transfer that, let's just say Redwood wants to buy that. So if I transfer to—Redwood buys that book of business, $200 million worth of guarantee business, how are we going to separate that from Freddie and Fannie? Because my interest is, obviously, getting the taxpayers out of this business.

Mr. HUGHES. It wouldn't be that simple. Potentially, but there is a model out there on the multi-family side, on Freddie Mac deals right now, they sell off first loss risk to the people that are putting those down and basically putting themselves in a second loss position.

There are shelves available currently that the GSEs have where they can, again, sell off a piece of first loss risk, but it would be something that we would need it to be carefully thought through and carefully think through the impact on the TBA markets.

But I think it is an idea where I think there is an abundance of capital. And again, we are more credit investors and that would—to the extent that it met all of the criteria, we would invest in that and could put the government in a second loss position. It could really accelerate the process here.

Mr. NEUGEBAUER. I just wonder if the existing securitization documents would allow it?

Mr. RAJADHYAKSHA. There is a way to make it simpler. We have actually been discussing this with Treasury and the regulators, FHA and FHFA, for a while now. And the GSEs absolutely have the financial technology to do this, right? The key, as Michael said, is that the TBA market is not being backed up. The way that they do that is what Fannie and Freddie sell would be new debt, which behaves the way a first loss piece will behave.

So, the mortgage side of it would not be impacted at all, except that the performance of that first loss piece of debt that they sell. They have done this before. For example, the GSEs a few years ago started selling what was called final maturity bonds, which are, again, debt. It was not mortgage-backed securities, but it behaved the way a certain pool of mortgage-backed securities that they were referenced to actually behave.

Mr. NEUGEBAUER. So it would be a synthetic, basically?

Mr. RAJADHYAKSHA. The problem with synthetic is that counterparty risk comes into the question, right? So you would actually sell that. You would get cash, and that will end up building, starting to develop an insurance fund immediately. And what you would pass on is part of the g-fee from the mortgages that you already originated.

Mr. NEUGEBAUER. So it is a reinsurance thing for Freddie and Fannie, basically?

Mr. RAJADHYAKSHA. To allow the private sector to take on that—

Mr. NEUGEBAUER. To take on that risk.

Mr. RAJADHYAKSHA. Yes.

Mr. HUGHES. You could do it, one way to do it is you could do it through some form of synthetic, but it would need to be fully funded so that you didn't have the counterparty risk of, hey, it is an insurance company. Who insures the insurance company?

So, yes, I would think it would have to be fully funded up front, similar to a transaction on the private side.

Mr. RAJADHYAKSHA. Sell it for cash.

Mr. NEUGEBAUER. Table number two have some thoughts on that?

Mr. ROSNER. Yes. I think your concern about the transfer of risk is the correct one, and I don't know how you would actually make investors comfortable that what was an implied government or at this point functionally explicit government guaranteed asset, it will no longer be once it is in the hands of private investors or purchased outside of the GSEs.

Mr. NEUGEBAUER. But if Freddie and Fannie, I guess, stay in the chain here, is—I think is being implied where they are just then selling that risk off. In other words, they are buying—

Mr. ROSNER. Then I am not sure it really actually represents a real tracking instrument, as you are intending.

Mr. NEUGEBAUER. Yes?

Mr. LIEBERMAN. I would agree with Ajay that Freddie Mac has done what they call the K series deals in the multi-family world. They sell off the first loss piece. It trades between an 8 and 10 percent yield. It seems a very attractive level for Freddie to sell that risk off, an 8 to 10 percent yield for first loss piece.

And I think the thing that should be taken advantage of, over the last 5 years, private investors have developed quite a bit of credit expertise on housing. Maybe not because they wanted to, but unfortunately, we have all become experts in credit, and we have all basically halted any sort of reliance upon rating agencies.

And it would seem that you would have a very, very deep and broad market to sell credit risk off on the GSE portfolios, and there is a variety of ways to do that, some more complicated, some less. But the investor appetite is there. The capital is there. It is just a question of the willingness to allow a little bit of sunshine into that market and see how it progresses.

Mr. NEUGEBAUER. My last question is just a quick one. We are talking about creating a space for the private market and, obviously, with the loan limits coming down at the end of this month. But what if Freddie and Fannie said, for example—and they have the ability to do this—that instead of 125 percent of the medium price, that we are going to do 110 percent of medium price?

How much new space does that create for—do you have just an idea? I know that requires some statistics. But would that create 10 percent new demand in the private market?

Mr. RAJADHYAKSHA. At current credit levels, it would probably create 10 to 15 percent more demand, we expect, in the private market. But one thing I would add to that is that now is as good a time as any to transition to the private sector as far as new origination goes because credit standards for new origination for Fannie Mae and Freddie Mac are also reasonably tight.

So what you are looking at is there is not going to be if the private sector ends up replacing Fannie and Freddie, you should not get a drop-off in mortgage credit availability, which is the biggest concern for all of us here.

Mr. NEUGEBAUER. So if you lowered, you don't think you are going to see a drop-off in availability?

Mr. RAJADHYAKSHA. I do not think you will see a drop-off in availability right now because the loans that, like Marty said, Fannie and Freddie are originating post 2009, the new loans, that is, are very tight credit, have a very tight credit space.

Mr. NEUGEBAUER. So, that would create some space then. It would create some space? Yes.

And without—Ajay, I think what I am hearing is without causing a lot of major disruption in the credit availability based on the current conditions?

Mr. RAJADHYAKSHA. Yes. If you transitioned, if you had tried to transition, say, 5 or 6 years ago when Fannie and Freddie were a much bigger share of the market and the credit box was looser than—

Mr. NEUGEBAUER. You might have created some space. Mr. Rosner, 110 percent?

Mr. ROSNER. I think it would free up—I agree with Ajay generally. I think the big question is does it do anything to really restart the private label market, as opposed to it just ending up on bank balance sheets, which is fine, to some degree, to take that pressure off of the government and put it back on private balance sheets.

But I still think we need to first address the plumbing—sorry to use that again—and documentation and origination issues.

Mr. LIEBERMAN. I would assume that it would open up some room, but I don't have a figure in mind on how much room would open up.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Chairman GARRETT. Thank you.

The gentlelady from New York is recognized.

Dr. HAYWORTH. Thank you, Mr. Chairman.

It certainly sounds as though, fundamentally, what we are talking about is essentially rationalizing the mortgage marketplace to make it appealing for private investors, to make it a common-sense decision to do that. Right now, we don't have that because the Federal Government has so intervened against common sense in the marketplace.

Is that a correct impression? Essentially, what you are saying, Ajay, is that Fannie and Freddie now have adopted behaviors that come closer to resembling what a marketplace would demand?

Mr. RAJADHYAKSHA. Right. So if I may take a step back? Of the $5 trillion or so of the agency mortgage-backed securities market that is currently outstanding, our sense is that suppose Congress decided that tomorrow morning they wanted to transition to the private sector, right, all in one day? Fifty percent, about 50 percent of that market, worth $2 trillion to $2.5 trillion, should be able to transition without their mortgage rates going up.

Another $1.5 trillion or so, another 25 percent, will be able to transition with the mortgage rates rising by 100 or 150 basis points.

Dr. HAYWORTH. Because right now they are just too low?

Mr. RAJADHYAKSHA. That is correct. And the bottom 15 to 20 percent will have rates that are considerably higher. The point, though, is that the loans that have been currently originated even by Fannie and Freddie are in the top 50 percent.

Dr. HAYWORTH. Right.

Mr. RAJADHYAKSHA. So that transition should not be—we want it to happen smoothly and slowly, but it should not be too much of a problem.

Dr. HAYWORTH. So, we have made movement toward that kind of a transition, in a sense. We are preparing the housing marketplace in general and the mortgage marketplace in general in the United States for that to happen? Okay.

I had a question regarding something a bit more specific, if I may? There is a program called PACE, Property Assessed Clean Energy, and in mid-2010, FHFA determined that participants in—which is 90 percent of mortgage holders in the United States, those who have mortgages backed by Fannie Mae and Freddie Mac, homeowners, property owners—could not participate in Property Assessed Clean Energy programs.

Are those familiar to everyone here? Because it represented essentially senior debt, and in the case of foreclosure, FHFA determined that that would be an obstacle to collecting on the loan.

I have introduced legislation to enhance the appeal of the program to FHFA so that they will be assured that the likelihood of PACE participation getting in the way of recovery would be very low. Do you think the private marketplace would have any similar difficulties in accepting a PACE assessment as part of a property owner's range of obligations? Any of our panelists or all of them?

Mr. RAJADHYAKSHA. I, unfortunately, don't know enough about the details of this program.

Dr. HAYWORTH. Just briefly, the PACE programs allow property owners to make energy-saving improvements on their homes or structures and to finance them through a property tax assessment that is allowed by the issuance of municipal bonds from a special taxing authority that is granted to a community. And every State has to authorize this kind of a program for its communities. New York has a PACE program, as do 26 other States and the District of Columbia.

But currently, as mentioned, as of June 2010, when FHFA took receivership of Fannie Mae and Freddie Mac, they were excluded, 90 percent of mortgage holders were excluded from participating in PACE. And in this kind of environment, given that we would like contract just to go back to work, we would like to encourage energy-saving practices, PACE seems like a win-win.

So I am endeavoring, along with colleagues in our House, to make it possible for FHFA to find its way to allow Fannie Mae and Freddie Mac mortgage holders to participate. But because it is viewed as—if there were a foreclosure, it would be viewed—obviously, it is a tax-related obligation. It would be viewed as senior debt. They view it as problematic, even though the rate of foreclosure for PACE property, PACE assessment holders is actually lower than that for those who don't have them. So—

Mr. RAJADHYAKSHA. I think if it occupies the same position in the pecking order when they went to foreclosure as property tax liens do, then—which already exists—then I cannot know why—it would just have to be very clear cut in that situation.

Dr. HAYWORTH. Okay. Thank you.

Any of our other panelists?

Mr. LIEBERMAN. I think investors price a mortgage based upon three general characteristics—credit, character, and collateral—the "three Cs" of old-fashioned banking. If a PACE loan jumps ahead of the collateral, your house that you are going to foreclose upon, that is going to affect the valuation of that secured interest. And you are going to either have to price the mortgage higher, or you are going to have to decide that the collateral is not worth as much and the recovery is not going to be as much. And it will affect pricing.

A tax lien is typically maybe 1 to 2 percent of assessed value, and you can figure out what the timeline is for foreclosure and how much is going to accrue and factor that into the loss.

On the PACE side, if you give a loan to a borrower and then a year later, they put a $50,000 solar panel complex on top of the house that jumps in front of your mortgage, it is certainly going to add value to the house. But you are uncertain what has happened to your collateral package. I think that throws some doubt in there.

Dr. HAYWORTH. So, there have to be ways in which we can consider the technical aspects, if you will, of the financing. Yes, sir?

Mr. Hughes or Mr. Rosner?

Mr. HUGHES. I would agree with Mr. Lieberman.

Dr. HAYWORTH. It wouldn't necessarily exclude a property owner from having a privately secured—

Mr. LIEBERMAN. It wouldn't exclude it. But I would think that there probably has to be some upper boundary to the amount that can jump in front of the lien. There has to be some way to quantify it. Otherwise, we can't price for the risk, and it becomes, once again, very much like, unfortunately, the securities we already own, where we thought we had an owner-occupied house and it turned out to be an investor house.

So that, subsequently, down the road a year or two later turns out to be something else, we are not going to, unfortunately, get our capital back.

Dr. HAYWORTH. Understood. Thank you.

Chairman GARRETT. And I thank you.

That concludes the first round, and I see we are approaching the top of the hour. So what I thought we might want to do is our all-famous lightning round at this point and just allow, since some of the members indicated they may have a couple of other questions, just 2 minutes for each member.

My vice chair said he will be strict on the time clock mechanism here, and then we will allow the panel to be dismissed.

Going very quickly, I think Ajay's comment will be the take-away from today, that now is as good a time as ever to move on these areas. So, I think that will be the take-away from this panel discussion.

Let me just run down a couple things just to reaffirm. On TBA, which I questioned Mr. Rosner on—and others talked about as well—it seems as though we could actually re-create a different type of TBA market, as long as we get the underwriting standards, homogeneity in the marketplace there, uniformity in the underwriting standards. Correct? Okay.

To that, a side note, though. Mr. Hughes made some comment—I don't know if this is on point or not—saying that some of our suggestions that have been out there floating is to say that we come up with some standards as far as what is prime, what have you, and some have suggested that you have multiple, prime and subprime.

So, again, you would have some—you all would be able to take a look at and whether you just come and put one or, some have suggested, sort of a good, a bad, and a not so good. Your comment was that you really only need one on that area?

Mr. HUGHES. No, no. I think you need multiple definitions.

Chairman GARRETT. Okay.

Mr. HUGHES. So that we are clear what a prime loan is, the Alt-A loan is, and the subprime loans are. That is what we need, a distinction.

Chairman GARRETT. Good. I just wanted to clarify that.

Ajay, on your opening comment with the—and Randy followed up on with regard to the credit risk aspect of it, that is a neat idea there. One, I guess, upside of that—I guess, is maybe this is where you were going—is that if you did that tomorrow, that would be able to help the market be able to do what? To be able to price the g-fees effectively is the way I am understanding this.

Mr. RAJADHYAKSHA. Right. It would help the market to price mortgage credit, more like a benchmark or—

Chairman GARRETT. Yes. So I got that the first time, but Randy's comment, sort of following up on that, says another aspect of that is actually pricing what the g-fees should be, going forward.

Mr. RAJADHYAKSHA. That is correct. That is correct, and then you, as Congress, get to decide whether you want to subsidize certain out of the mortgage universe and would you increase loan subsidy costs here.

Chairman GARRETT. Right. And so, if you do that, you price that, you set g-fees, that goes to Mr. Hughes's comment or questions on that with Mr. Hughes as far as them being able to say if they are priced correctly, that market basically opens up.

Mr. HUGHES. The market opens up. And again, if you did that on a basis where the private market was pricing effectively the credit, you would need a rating agency, which is an obstacle right now, an impediment of getting real velocity on the package—

Chairman GARRETT. And the last point, just running through this, with regard to the whole second lien issue here, we understand the problem as it exists today, most of us understand that in the market today, it is particularly tough to get a second lien anyway out there.

I just want clarification that if tomorrow we were to change the law one way or the other, and you have different variations on what these tools should be in regard to the limit on second liens, if you will, what does that look like in the marketplace, going forward, as far as my ability to own a home, to have a first mortgage? What does that do to my ability to go out and get a line of credit or anything else like that at second lien?

Mr. HUGHES. Your ability, I believe you couldn't use your house as an ATM.

Chairman GARRETT. Correct.

Mr. HUGHES. You use it on a responsible basis so that if you put 20 percent down and your house went up by 10 percent, you could borrow 10 percent of the original amount. But you can't just go out the next day and withdraw your equity in the house—

Chairman GARRETT. Interesting. I said that was my last question, but I just want to ask one last question. What does that do as far as structured in what way? Were you basically saying that the initial first mortgage holder is—on the first mortgage or the limitation on—

Mr. HUGHES. The bank you go to initially has to sign off on that. It doesn't have to enforce the—it doesn't have to necessarily raise the rates that you would have to have for the second lien unnecessarily high.

Chairman GARRETT. So, that would not be the solution to doing that?

Mr. HUGHES. Correct.

Chairman GARRETT. Okay. Any other comments on any of the questions I had?

Mr. LIEBERMAN. I want to add that basically putting some controls around the second lien will stabilize home values going forward. You will have less potential volatility, and so there will be more equity offered on homes to absorb that volatility.

You actually may increase the velocity of home sales because you have access once again. Your house went up in value, you basically could go out and sell the house and you could buy a new one, which adds viability to commercial outcomes for the borrower as well as for—

Chairman GARRETT. That is interesting. What that actually proves then—that this proves that this is good for the real estate market. It is actually good for those who are actually certain they want to sell and they could have an availability, what-have you, and you can actually see that long term.

Mr. ROSNER. It would be great if this committee could promote the ideas of allowing second liens because it is really not anywhere. It has fallen through the cracks. Every time we talk to somebody, they mention [inaudible], but we can't touch it.

And so, it would be great if this committee could put forward ideas on different ways—there are lots of different ways to do it. But I think it would be warmly embraced by private investors to know that the first lien would be this protected.

Chairman GARRETT. That is something that is part of our role.

I thank the panel for all their answers.

The gentlelady from New York is recognized.

Mrs. MALONEY. Thank you, Mr. Chairman, for having this meeting, this hearing.

[Inaudible] testified before the Subcommittee on Financial Services that 25 percent of our economy is healthy, and if we can't figure out how to move this forward and solve this problem, it is going to continue to drag down our economy.

I also want to note that it is the 10th anniversary of 9/11, and I want to thank my colleagues who were part of that recovery effort here in New York. Most of your districts sent people who worked and helped us recover. We appreciate that.

And after this, after the 9/11 recovery, we are meeting on 9/11. We are still recovering, still working on it.

I want to ask Mr. Rosner a question really that concerns Attorney General Eric Schneiderman. He recently was thrown out of a coalition by Attorney General Tom Miller of Iowa, a coalition of attorneys general who were seeking to get something on financial institutions, and Attorney General Schneiderman said he didn't believe that there had been enough effort to investigate servicers, and he was asked to be removed from the coalition.

So I would like to ask you, do you think that the 50 State attorneys general have robustly investigated the servicers' actions?

Mr. ROSNER. No.

Mrs. MALONEY. You do not?

Mr. ROSNER. No.

Mrs. MALONEY. Do you want to elaborate on how you don't think they robustly—

Mr. ROSNER. I think that there has been very little investigation, discovery, very few depositions. We have had a rush to settlement, it seems, which is beyond just on the original robo-signing that was talked about. So it would include at least the liabilities for front-end issues and servicing broadly without any real investigation.

I don't think Attorney General Schneiderman being thrown out of the committee matters very much because, at the end of the day, he would have to sign on to any agreement for it to be a 50-State agreement.

But I don't think there has been a real consideration, and I think, frankly, these suits that continue demonstrate that there has not been enough investigation, which would help private parties if there was more as well.

Mrs. MALONEY. So, in other words, you think that Attorney General Eric Schneiderman is correct to continue investigating servicers before signing on and that this is an important part of moving forward.

I want to thank all of you. I think I have met a new source of people to call for input on many things that are happening before this committee.

Again, thank you, Mr. Chairman, for bringing this hearing to New York. We appreciate it.

Thank you.

Chairman GARRETT. Mr. Schweikert?

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

And coming from Arizona, you have this funny thing that falls out of the sky here.

[laughter]

Mr. SCHWEIKERT. I live in the middle of the desert. That is actually funny. And actually, as you notice, I didn't turn on the timer when the chairman was speaking. You learn how to kiss up to your chairman.

Okay. Let's do some of this quickly.

Mr. Lieberman, externality on the pricing of loans is one of the discussions we keep having. Arizona is a deed-of-trust State. It can theoretically foreclose in 91 days. A mortgage State could take you a year, with much higher litigation costs. Should that be priced into the loan?

Mr. LIEBERMAN. I believe it is already. When we price, we price in the actual process, and we also price in who is servicing the loan currently. Different servicers have different processes.

Mr. SCHWEIKERT. Okay. And then, Mr. Hughes, when you were buying your loans to package up and securitize and sell them, did you look at them geographically to see if they were in higher regulatory or difficult areas to—

Mr. HUGHES. When we analyze loans, we analyze them by MSA or by zip code, and we have an opinion on every single zip code.

Mr. SCHWEIKERT. Okay. And I assume within that formula is—

Mr. HUGHES. Absolutely. There are different timelines, and I think one other thought here is probably the best thing we can do is put more efforts in preventing foreclosures than mechanisms on the back end. And I am serious about that. If we can make sure borrowers can—day one, a borrower can clearly afford the house.

Mr. SCHWEIKERT. Part of that question is coming. Because certain States create greater impediments, and—

Mr. HUGHES. Absolutely.

Mr. SCHWEIKERT. —if you have a federally-backed system, the rest of the taxpayers across the country are basically subsidizing the impediments from that State and getting subsidized by other States having more efficient systems.

So, it is sort of an externality question that is a little ethereal, but he only gave me 2 minutes.

Ajay, one quick one. When you say selling off the first loss piece—

Mr. RAJADHYAKSHA. Right.

Mr. SCHWEIKERT. First, how big? If you and I were looking at it in strips of the loan—

Mr. RAJADHYAKSHA. Sure.

Mr. SCHWEIKERT. —what part would I be actually looking at?

Mr. RAJADHYAKSHA. What would you be looking at is, basically, debt that corresponds to the hit that the mortgage-backed security would take on liquidation, which is—

Mr. SCHWEIKERT. Okay. So I would be discussing, basically, the subordinated strip?

Mr. RAJADHYAKSHA. It would be, absolutely. In a capital structure, that would be what the subs will be called, yes.

Mr. SCHWEIKERT. And you think that might be a way of helping finance a, we will call it a guarantee?

Mr. RAJADHYAKSHA. It does two or three things. Number one is it immediately starts to build up a cash insurance fund for Fannie Mae and Freddie Mac, which they do not have right now. Number two, and most importantly, it does provide a benchmark for the private sector to price mortgage credit off of. And number three, even the GSEs for a while are going to continue originating loans. It gives them a market-based signal on whether the g-fees that they are charging are market-based or not or whether they are way off market.

Mr. SCHWEIKERT. All right. Ajay, thank you.

Thank you, Mr. Chairman.

Chairman GARRETT. The gentlelady is recognized.

Dr. HAYWORTH. Thank you, Mr. Chairman.

I am thinking synthetically in a sense. When we had a covered bond hearing, I believe it was in April, Mr. Chairman, a representative of the community banks was concerned about the developing covered bond marketplace because, as I am recalling, if I am recalling correctly, there was a certain amount of fear that community banks would have not the wherewithal, if you will, to use a very broad term, to participate in it.

Would developing—and I am thinking of underwriting standards as well because our community bankers will contend, and certainly intuitively it makes sense. They know their mortgage holders well. So, there is that relationship. There is that quality of the character reference, if you will. There is a relationship with the communities. We have a lot of community banks in our district. I am sure that is true pretty much of districts across the country. And we have big banks, too.

Would a fuller development of a private residential mortgage-backed securities marketplace alleviate some of those concerns, if you will, on behalf of our community banks regarding covered bonds?

Mr. RAJADHYAKSHA. I think, absolutely, it would. It is a fair point that the covered bond market would be far more accessible to big banks, but you can also make that argument about the corporate bank market. Banks are allowed, last I checked, to issue corporate debt, right?

It is true that a securitization market would probably provide a concertedly more level playing field. It would not be named specific, and community banks will have a greater shot at funding their mortgages.

Mr. HUGHES. Another mechanism that I believe could work that could provide liquidity to the community banks if they don't have portfolio capacity is to aggregate the loans that they have. You would probably have to use the Federal Home Loan system and have them intermediate and sell it to a company like Redwood Trust, where you can make sure that the Federal Home Loan System is not taking any risks, but you would funnel it through in a way that would bring liquidity for jumbo mortgages and others that they couldn't otherwise sell.

Because otherwise, right now, if you are a small community bank, you can't portfolio it. You are forced to sell it to a bigger bank, and generally, you lose your customer when you do that. But I think that is another opportunity.

Dr. HAYWORTH. Thank you.

Mr. Rosner?

Mr. ROSNER. I agree.

Dr. HAYWORTH. Okay. Mr. Lieberman?

Mr. LIEBERMAN. I agree.

Dr. HAYWORTH. Thank you all.

Thank you, Mr. Chairman.

Chairman GARRETT. And the gentleman from Arizona is recognized yet again.

Mr. SCHWEIKERT. Mr. Chairman, thank you.

And this is—some of us have already had this conversation over the last few months. I am hunting for ideas on the aggregator portion of, loan is written by the community bank, money center bank, mortgage banker.

How is it being collected and moved up to the securitizer, and if you were to do that on a very large-scale basis? And I would be elated for some suggestions because I have looked a little bit at your model and wondered how it would scale.

Mr. HUGHES. I think it could scale very well. I think you have—there are certain of the Federal Home Loan Banks that were aggregators in the past. I think, to use a word that has been used a lot, they have all the plumbing to be the aggregation source. And then I think the real trick, at that point in time, is to companies like Redwood would look to buy those loans.

We would, again, draw an underwriting box so if it looks like this, we would buy it, but I think there would be a vast amount of capital.

Mr. SCHWEIKERT. Mr. Chairman, to everyone on the panel, do you like the idea of using the Federal Home Loan Bank—

Mr. HUGHES. On a de-risked basis—

Mr. SCHWEIKERT. Yes.

Mr. HUGHES. —where really a true, true—

Mr. SCHWEIKERT. Yes, I was about to say with the caveat that there is a wall so the possibility of liability does not transfer into the participating institutions.

Chairman GARRETT. Can you do that?

Mr. HUGHES. I think you could do that. You can.

Mr. LIEBERMAN. I think it depends on if they are just another name for Fannie and Freddie.

Mr. SCHWEIKERT. Okay.

Mr. LIEBERMAN. If they are truly—are they providing a wrap? Are they providing just the plumbing, or are you basically just creating 12, or however many Federal Home Loan Banks there are, new Fannies and Freddies.

Mr. SCHWEIKERT. Yes. The concern would be the true classic aggregation. They acquire, they hold for 90 days. It is a tiny bit of seasoning until someone comes in and buys it.

Mr. HUGHES. I think you could buy them right at the time—we could make it a commitment. And again, there are two of the banks—actually, the primary one is the Federal bank in Chicago that has all the mechanisms in place right now, and I think you could distribute through them, and a company like Redwood will buy the loans.

Mr. SCHWEIKERT. Okay. We may have some future because this ties back into the "to be announced" market that I have been trying to finish that piece of the package.

So, Mr. Chairman, thank you. And gentlemen, thank you.

Chairman GARRETT. Again, thank you, all of the members of the panel. Thank you to all of my colleagues for joining us here in New York.

The Chair notes that some members may have additional questions for the panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their response in the record.

And with that, the hearing is adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

A P P E N D I X

September 7, 2011

Testimony of Martin S. Hughes

President and Chief Executive Officer – Redwood Trust, Inc.

Before the

United States House of Representatives

Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing on

Facilitating Continued Demand in the U.S. Mortgage Market Without a Government Guarantee

September 7, 2011 – New York, NY

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Introduction

Good Morning, Chairman Garrett, Vice Chairman Schweikert, Ranking Member Waters, and Members of the Committee. My name is Marty Hughes, and I am the CEO of Redwood Trust, Inc., a publicly traded company listed on the New York Stock Exchange that invests in mortgage credit risk. I appreciate the opportunity to testify on facilitating continued demand in the U.S. mortgage market without a government guarantee and look forward to responding to your questions.

Overview

My testimony is focused on restoring a fully functioning private-sector residential mortgage finance market. Currently, about 90% of all new mortgage originations rely on government support.[1] Given the fact that there is $9.6 trillion of outstanding first lien mortgage debt,[2] this level of public subsidization is simply not sustainable. Obviously the Committee understands this and I commend you for devoting the time and energy toward enacting appropriate reforms to draw private capital back into the mortgage market.

The main sources of private-sector capital that previously financed residential mortgages include banks, mutual funds, pension funds, and insurance companies. For the non-banks, the transmission mechanism for providing this financing was through their investments in triple-A rated residential mortgage-backed securities (RMBS). My testimony will recommend how to bring these "triple-A investors" back to this securitization market, thereby enabling the government to reduce its role in the mortgage market , and with the confidence that every creditworthy borrower will still be able to get a mortgage loan on reasonable terms.

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[1] 2011 Mortgage Market Statistical Annual, Volume I , page 19

[2] Federal Reserve Flow of Funds of the United States, Fourth Quarter, Tables L.217 and L.218

Background on Redwood Trust

Redwood Trust commenced operations in 1994 as an investor in residential mortgage credit risk. We are not a direct lender or mortgage servicer. Our primary focus has been on the prime jumbo mortgage market, or that portion of the mortgage market where the loan balances exceed the limits imposed by Fannie Mae and Freddie Mac (the "GSEs") for participation in their programs. Similar to the GSEs, Redwood also provides credit enhancement, but our focus is on the prime jumbo mortgage market. We provide credit enhancement by investing in the subordinate securities of private residential mortgage securitizations, which enables the senior securities to obtain triple-A ratings. We have invested in subordinate securities created by others' securitizations as well as subordinate securities created by our own securitizations. (From 1997 through 2007, Redwood securitized over $35 billion of mortgage loans through 52 securitizations and invested nearly $300 million in those securitizations.)

Recent Securitization Activity

In April 2010, Redwood Trust was the first company, and is so far the only company, to sponsor a securitization of newly originated residential mortgage loans without any government support since the market froze in 2008. The size of that first transaction was $238 million. In March 2011, we completed a second securitization of $295 million, and we anticipate that we will complete two more securitizations this year.

Completing these transactions required that we address the concerns and interests of triple-A investors who, in the wake of the financial crisis, had lost confidence that their rights and interests would be respected and, consequently, that their investments would be safe and secure. We worked hard to regain their trust by putting together transactions that included even more comprehensive disclosure, better structure, and a new enforcement mechanism for representation and warranty breaches. In addition, Redwood Trust retained meaningful exposure to the transaction's future performance — i.e., through risk retention or "skin-in-the-game" — and, in doing so, aligned our interests with those of investors. Investors responded with significant demand to acquire the triple-A rated securities, as evidenced by the fact that the first offering of those securities was oversubscribed by a factor of six to one. The second securitization was also quickly and fully subscribed.

To be clear, Redwood Trust has a financial interest in the return of private sector securitization for residential mortgages. We hoped that our decision to securitize loans in 2010 would demonstrate to policymakers that private capital would support well-structured securitizations that also have a proper alignment of interests between the sponsor and the triple-A investors. Based in part on the success of our two recent mortgage securitizations and on-going discussions with triple-A investors, we have confidence that the private market will continue to invest in safe, well-structured, prime securitizations that are backed by "good" mortgage loans. We consider "good" loans to be loans on properties where the borrowers have made real down payments, demonstrated an ability to repay, and have a good credit rating. We are proud of our history of sponsoring residential mortgage securitizations and of our more recent role in helping to restart the private securitization market, and we are pleased to have the opportunity to share our insights and observations with the Committee.

The Outlook for Private Mortgage Securitization in 2011

The outlook for nongovernment or private residential mortgage securitizations backed by newly originated mortgage loans ("new securitizations") in 2011 remains very weak by historical standards. Year-to-date through August 31, 2011, only one securitization of newly originated mortgage loans totaling $295 million has been completed, and that was our deal. There are no good industry estimates of new private securitization volume in 2011, as the market is still thawing from its deep freeze. While we would welcome other securitizations in 2011 to provide additional third-party validation of the viability of securitization, the yearly volume will be a small fraction of the $180 billion average annual volume from 2002 through 2007.[3]

IMPORTANT MARKET OBSERVATIONS

The Primary or Origination Half of the Private Market is Functioning

Contrary to the claims of some policymakers and market observers, half of the private residential market is functioning and originating nongovernment-guaranteed mortgages. According to Inside Mortgage Finance, the top ten jumbo mortgage lenders originated $25 billion in the first quarter of 2011 and originated $30 billion in the fourth quarter of 2010. Clearly, the nongovernment guaranteed origination segment of the private market is functioning well.

Some commentators contend that nongovernment guaranteed mortgage rates are so high that a substantial number of potential homeowners are priced out of buying a house. We believe this argument is without merit. There is a small rate difference (currently approximately 0.625%) between a conforming and a private jumbo mortgage loan, which can be verified by reviewing the rate sheet from any private market mortgage conduit buyer.[4] This premium is slightly higher than the loans in our last securitization in March 2011 (SEMT 2011-1) in which the mortgage rates on the underlying collateral averaged just under 0.50% higher than the conforming rate over the time period those loans were originated.

[3] 2011 Mortgage Market Statistical Annual, Volume II, page 31.

[4] On 9/1/11, the private jumbo mortgage rate quoted by GMAC was 4.75%, compared to an agency conforming loan at 4.125%%. The current 0.625% premium is slightly higher than the recent past due to spread widening across most risk assets due to the increased level of stress in the financial markets.

Beyond the issue of rate, let's look at who the higher loan limits are benefiting and consider whether those borrowers truly need a government subsidy. Consider the example of a $729,750 mortgage, amortized over 30 years at a fixed rate of 4.25%. (Assuming a 20% down payment, this mortgage will support the purchase of a house at a cost of $912,187.) The monthly mortgage payment on this loan is $3,590 compared to $3,807 if the rate is increased to 4.75%, a monthly payment increase of $217. While $217 may be too much to overcome for a borrower at the median income level, the borrower who can qualify for the $3,590 payment would need to have a gross monthly income of at least $12,821[5] (or $153,857 annually). An income of this amount is three times the real median household income.[6] Not all borrowers who qualify for the mortgage at 4.25% will be able to qualify at 4.75%. For example, the borrower who just qualifies for an 80% loan-to-value loan on a $912,187 house at 4.25% will still be able to qualify for an 80% loan on a slightly less expensive home priced at $860,255 at a mortgage rate of 4.75%. Importantly, we should ask whether taxpayers should be subsidizing the ability of higher income borrowers to buy a more expensive house, given the nation's debt crisis.

The Secondary Market Half of the Private Market is not Working

The segment of the private market that is not functioning well is the private securitization market. There are three reasons. First, there is currently no financial incentive for bank originators, who have historically been the dominate mortgage securitization sponsors, to securitize mortgage loans. According to the Federal Reserve's latest H.3 report, excess reserves (deposits that could otherwise be loaned to borrowers) in the banking system total $1.6 trillion, a truly staggering number, and those reserves are earning a rate of 0.25% per annum. The excessive reserves and the low interest rate

[5] A mortgage borrower's monthly mortgage payment cannot exceed 28% of gross monthly income per the underwriting standards of Fannie Mae and Freddie Mac.

[6] U.S. Census Bureau, Income, Poverty, and Health Insurance Coverage in the United States: 2009, page 7.

environment have reduced the cost of funds for the largest 50 banks to an average of 0.81% in the second quarter of 2011.[7] Banks have a strong financial incentive to hold loans that cannot be sold to Fannie Mae or Freddie Mac in their portfolios to earn the spread between the mortgage yields (currently about 4.75% for jumbo loans) and their low cost of funds.

The second reason is that the government is crowding out the private market through loan programs that make 90% of borrowers eligible for a below-market-rate government guaranteed mortgage loan. Private capital simply cannot compete with government subsidized mortgage programs.

Third, there is a need to resolve several key regulatory and market issues, including reform of underwriting and servicing standards, greater investor protections, and addressing the second mortgage problem. The current lack of a financial incentive for banks to securitize RMBS will self correct over time with an improving economy, but it is critical that regulators and industry practitioners address structural issues so that there will be a functioning private RMBS market. Without a functioning private market, there can be no material GSE reform that restarts the mortgage market without a government guarantee.

It's Not That Hard to Fix the Mortgage Market

The mortgage market worked very well for many years, and the private market share averaged over 50% from 1985 through 2007.[8] Over much of that period, annual losses were very low and averaged about 10 to 15 basis points per annum. Loan modifications (or the need for them) were virtually unheard of. In summary, the mortgage market worked well.

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[7] SNL DataSource

[8] The government share was calculated by dividing the annual securitization volume of Fannie Mae, Freddie Mac, and Ginnie Mae by the industry origination volume, based on data obtained from 2011 Mortgage Market Statistical Annual, Volume I, page 19.

So what changed to cause the mass destruction of so much of the financial wealth of borrowers and the financial markets? The real answer could take well over 600 pages as noted by the report of the Financial Crisis Inquiry Commission and the dissents, but our view is that the main culprit was a serious decline in mortgage underwriting standards. When combined with declining standards and requirements in virtually every other aspect of the origination-to-securitization chain, destruction resulted.

Fixing the mortgage market is not complicated if the problem is broken down to its components, mainly making a distinction between the prime market, which represents about 90% of the mortgage market, and the non-prime segment, which represents the rest of the market. Reforms needed to restore basic functioning of the prime mortgage market are different in nature from the reforms needed to prevent future abuses in the subprime market. A new regulation designed to accomplish one objective can easily do great harm to fulfillment of the other objective, if applied to both. We see that happening with much of the Dodd-Frank rulemaking.

We strongly believe that if the policymakers would focus first on restoring the prime mortgage market, resolution would be much faster and benefit the largest section of the market. The complexities related to risk retention, premium capture, qualified mortgages, and conflicts of interest are largely related to the subprime market, not the prime market.

MAJOR STRUCTURAL HURDLES TO RE-STARTING THE PRIVATE RMBS MARKET

1) The Government is Crowding Out the Private Sector

The government must begin to reduce its participation in the mortgage market, and allowing the temporary increase in the conforming loan limits to expire at the end of September 2011 would be a good first step. Through the GSEs and the Federal Housing Administration (FHA), the government has stepped in and taken the credit risk on about 90% of the mortgages originated in the U.S., without passing on the full cost of the risk assumed. Government subsidies must be scaled back to permit a private market to flourish. We note that post-crisis, the private asset-backed securities markets for auto loans, credit cards loans, and now commercial real estate loans are up and functioning, while the private RMBS market barely has a pulse. The difference is the pervasive below-market government financing in the residential mortgage sector that is crowding out traditional private market players.

Critics will argue that Redwood Trust's transactions were backed by unusually high quality jumbo mortgage loans and are therefore not representative of the market. In fact, that argument proves the point that the government is crowding out private securitizations, by maintaining an abnormally high conforming loan limit and by subsidizing the guarantee fees that the GSEs charge issuers. No private sector securitizer can compete with that – we can only securitize the small volume of prime quality loans beyond the government's reach. We are ready to purchase and securitize prime mortgage loans of any loan amount, and can do so at an affordable rate once the government creates a level playing field.

We strongly advocate testing, on a safe and measured basis, the private market's ability to replace government-dependent mortgage financing. The reduction in the conforming loan limit in high cost areas from \$729,750 to \$625,500 represents about 2% of total annual industry originations[9], which we view as a small measured step. As noted above, there is ample liquidity and origination capacity in the banking system to allow banks to step into this small breach, while financing through private residential mortgage securitization regains its footing.[10]

The private mortgage market has already begun to demonstrate a capacity to meet the challenge. With the conforming loan rate scheduled to adjust in less than 30 days, a smooth transition is currently underway. Originators have implemented strict policies for closing loans at the higher limit by a date certain, in some cases by September 15. This allows a proper cushion of time to ensure new conforming loans get funded and sold as planned. In addition, secondary market buyers of jumbo loans, including Redwood Trust, are issuing rate sheets to originators for the purchase of jumbo loans above the new loan limit.

The market is successfully preparing to step in and fill the void, or opportunity, created by the lower loan limit. This is the kind of incremental step the government should take, in conjunction with the right supportive reforms, to permit the private market to develop.

Additionally, the Administration should follow through on its plan to increase guarantee fees to market levels over time to eventually level the field between the private market and the GSEs. A gradual

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[9]Federal Housing Finance Administration's Mortgage Market Note 11-01, page 4, Fannie Mae and Freddie Mac originated "just over \$30 billion" of conforming jumbo loans in 2010, compared to \$1.57 trillion of total industry originations.

[10] Excluding Bank of America's \$4.1 billion of jumbo mortgage production in the first quarter of 2011, the remaining three major banks (Wells Fargo, Chase, Citi) funded \$10.3 billion of jumbo loans, which annualized to \$41 billion exceeds the \$30 billion of conforming jumbo loans purchased by Fannie Mae and Freddie Mac in 2010. On 8/31/11, Bank of American announced it was going to exit the correspondent lending channel, which may reduce its jumbo origination volume. However, not all of the bank's jumbo loan volume was originated through its correspondent channel.

government withdrawal from the mortgage market over a five-year period will enable time for a safe, attractive, robust private market to develop.

As the housing market begins to recover, we support further measured reductions on a periodic basis in the conforming loan limit as a means of continuing to diminish the role of the government in this market and reduce the related risk to taxpayers, and as a result increase the share of the mortgage market available to the private sector. We note that with housing prices now down in excess of 30% from their peak in mid-2006[11], it would seem logical to consider reducing the conforming loan limit by a similar amount over time.

2) No financial urgency to challenge the status quo

We note that keeping the status quo (high conforming loan limits and government involvement in the mortgage market) effectively prevents the creation of any sense of urgency to restore private securitization, especially by traditional bank securitization sponsors. These major banks benefit by selling 90% of their mortgage originations into a very attractive government bid, and they have ample balance sheet capacity to easily portfolio the remaining jumbo loans and earn an attractive spread income. There is simply no financial incentive at this juncture for banks to sell loans through a non-agency securitization.

During the onset of the financial crisis, it was essential for the government to increase its support of the mortgage market. Today, that crisis level of support and the on-going burden on taxpayers to support 90% of a $10 trillion market is simply untenable. We strongly advocate that the time has come to more

[11] S&P/Case-Shiller Home Price Index press release dated April 26, 2011.

broadly demonstrate the private market's ability to replace government-dependent mortgage financing, and do so on a safe and measured basis to prevent negative consequences to the housing market.

3) Regulatory

In the wake of the Dodd Frank Act, there are many new regulatory requirements and market standards out for comment that are not yet finalized. The resulting uncertainty keeps many market participants out of the market. Once the rules of the road are known, market participants can begin to adjust their policies, practices, and operations.

A) Dodd-Frank Act Implementation Overview

We recognize joint regulators had a very difficult task in establishing, writing, and implementing the new rules as required by the Dodd-Frank Act. Before noting some specific concerns, we would like to offer some high level observations on the joint regulators' notice of proposed rulemaking on risk retention (NPR).

The NPR as written has some technical definitional and mechanical issues that need to be fixed, first and foremost among them, how the premium capture account works. This issue has been the source of much debate by market participants. We are hopeful that appropriate corrections will be made after all comment letters are reviewed.

We also note that regulators took a well intentioned approach to crafting a new set of risk retention rules to cover the entire mortgage securitization market – i.e., both the prime and subprime markets. In theory, this comprehensive approach should be a more expedient method for restarting securitization.

However, there are complex differences between the prime and subprime markets and their unique securitization structures that make it very difficult to apply a one-size-fits-all set of new rules.

The details are too complex for this testimony, but to over-simplify, the proposed rules are effectively subprime-centric. While the rules do a good job of addressing and deterring abuses relating to subprime securitization structures, they are overly and unnecessarily harsh when applied to prime securitization structures. This is meaningful since prime loans are approximately 90% of the overall market. If the proposed rules are adopted as written, prime borrowers (whose loans are financed through private securitization) will face unnecessarily higher mortgage rates.

In Redwood Trust's comment letter to the NPR, we proposed a more tailored approach that would keep intact the necessary safety protections, but eliminate the unnecessary structural inefficiencies that would lead to higher prime mortgage rates.

We believe that focusing first on restoring the prime segment of the market in a safe yet efficient manner would bring the greatest benefit to the largest number of stakeholders (borrowers, lenders, investors, and taxpayers) and would be more effective and productive than attempting to craft one all-encompassing regulatory solution that is likely to be challenging to implement given the complexities of the non-prime segment of the market.

B) Form of Risk Retention

We are strong advocates of requiring securitization sponsors to retain risk in order to properly align their interests with those of investors. We support the intent of the joint regulators' NPR on this issue.

In fact, it has always been Redwood Trust's operating model to retain the first-loss risk in our securitizations.

The NPR proposes four forms of risk retention: 1) a horizontal slice consisting of the most subordinate class or classes; 2) a vertical slice with pro-rata exposure to each class; 3) a combination of horizontal and vertical slices; and 4) a randomly selected sample of loans.

Redwood Trust believes the most effective form of risk retention is the horizontal slice and that other forms are much less effective. The horizontal slice requires the sponsor to retain all of the first-loss securities and places the sponsor's entire investment at risk. Only that approach will provide the required incentive for a sponsor to ensure that the senior securities are backed by safe and sound loans, which will benefit borrowers as well as investors.

The other forms of risk retention result in substantially less of the sponsor's investment in the first risk position, which reduces the incentive to sponsor quality securitizations. Over time, we believe investors will vote on the best form of risk retention and reward sponsors that retain horizontal "skin-in-the-game."

C) Qualified Residential Mortgages

We support the intention of the proposed definition of a qualified residential mortgage (QRM), but we believe it is a bit too restrictive. We support the concept of "common sense" underwriting, similar to the standards used by the GSEs for so many years prior to the period leading up to the credit bubble. These standards resulted in low credit losses for many years.

D) Servicer Functions and Responsibilities

We believe that the well-publicized mortgage servicing issues are an impediment to broadly restarting private residential mortgage securitization. Beyond the issue of lost documents and foreclosure practices, servicers have been on the front lines throughout the recent crisis. Focusing more narrowly on their role in the securitization structure, they have sometimes been placed in the position of having to interpret vague contractual language, ambiguous requirements, and conflicting direction. In their role, they are required to operate in the best interest of the securitization and not in the interest of any particular bond holder. In practice, without any clear guidance or requirements, they invariably anger one party or another when there are disagreements over what is and is not allowed – with the result of discouraging some triple-A investors from further investment in RMBS. We propose that uniform standards governing servicer responsibilities and conflicts of interest be established and that a credit risk manager be established to monitor servicer performance and actions. We have discussed this servicing issue in greater detail and have offered recommendations in our Guide to Restoring Private-Sector Residential Mortgage Securitization, which is available on our website.

4) Investor Protection

It is critical that policymakers understand the role of investors in the private mortgage market. Simply put, investors have the money, and there will be no material reduction in the government's role in the mortgage market without investors agreeing to increase their participation. Investors want a fair return on their investment; to have information about what they are investing in through access to increased data on the underlying collateral; simpler securitization structures; to know if there are any potential conflicts of interest with and among the originator, servicer, and sponsor; an alignment of interests with the sponsor; and confidence that their rights will be respected under contract law. Investors must have confidence that they will be protected from losses on the underlying collateral through improved originator representations and warranties on the collateral sold to the securitization trust and that there is an effective enforcement mechanism (such as the mandatory binding arbitration that we used in our last two securitizations). We propose the establishment of national uniform standards for servicers' rules and responsibilities, along with benchmarks that allow for the removal of the servicer for poor performance.

5) Second Mortgages

If we really want to restore a safe securitization market, we also need to address second mortgages. One of the significant factors that contributed to the mortgage and housing crisis was the easy availability of home equity loans. Plain and simple, the more equity a borrower has in his or her home, the more likely that borrower will continue to make mortgage payments. Home equity loans often result in the borrower having little or no equity in their homes.

Although the proposed QRM standard will encourage lenders to originate loans to borrowers who have a minimum 20% down payment, there is no prohibition against the borrower immediately obtaining a second mortgage to borrow back the full amount of that down payment. The addition of a second mortgage that substantially erodes the borrower's equity and / or substantially increases a borrower's monthly debt payments increases the likelihood of default on the first mortgage. Many of the current regulatory reform efforts are centered on creating an alignment of interests between sponsors and investors through risk retention or "skin-in-the-game." However, the first and most important line of defense is at the borrower level. If the borrower can take his or her own "skin" out of the game through a second mortgage, what have we really accomplished? The answer is very little. We believe any failure to address borrower skin-in-the-game will be very discouraging not only to private RMBS investors, but all mortgage investors including FDIC-insured institutions.

To prevent the layering of additional leverage and risk, it is common in other forms of secured lending (including commercial and corporate lending) to require either the consent of the first mortgage holder to any additional leverage or to limit the new borrowing based on a prescribed formula approved by the first mortgage holder. We recommend extending this concept to residential mortgages.

Specifically, we recommend enactment of a Federal law that would prohibit any second mortgage on a residential property, unless the first mortgage holder gives its consent. Alternatively, a second mortgage could be subject to a formula whereby the new combined loan-to-value (based on a new appraisal) does not exceed 80%.

Conclusion

Looking ahead to the long-term future of housing finance, I see a number of positives emerging: safer mortgages that borrowers can afford, the return of loan loss rates to historically low norms for newly originated prime loans, and private capital willing to fund residential mortgages at affordable rates for borrowers through responsible, safe securitization. The first step is to give the private sector a chance by following through on the Administration's plan to reduce the conforming loan limits and increase the GSE's guarantee fees to market rates at a safe and measured pace.

Thank you for the opportunity to testify before the Committee today. I would be happy to answer your questions.

AMI ASSOCIATION OF MORTGAGE INVESTORS

WRITTEN STATEMENT

ON BEHALF OF

THE ASSOCIATION OF MORTGAGE INVESTORS (AMI)

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES
FINANCIAL SERVICES SUBCOMMITTEE ON
CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

THE STATE OF SECURITIZATION MARKETS

SEPTEMBER 6, 2011

by JONATHAN LIEBERMAN,
ANGELO, GORDON & CO.

Introduction

Chairman Garrett and Ranking Member Waters, and distinguished members of the Subcommittee, thank you for the opportunity for the Association of Mortgage Investors (AMI) to testify and comment on this critically important topic of "Facilitating Continued Investor Demand in the U.S. Mortgage Market Without a Government Guarantee."

The Association of Mortgage Investors (AMI) commends you and your House colleagues for your leadership in pursuing responsible and effective oversight and vigilance to enhance the health and effectiveness of the U.S. financial markets, and in particular, the U.S. housing finance system. Facilitating future investor demand in the mortgage market will require addressing a number of current market problems which are presently obstacles for private capital returning to the securitization space. In summary, currently mortgage investors suffer from a number of problems in the securitization space including:

- Market opacity, an asymmetry of information, and a thorough a lack of transparency;
- Poor underwriting standards;
- A lack of standardization and uniformity concerning the transaction documents;
- Numerous conflicts-of-interest among servicers and their affiliates;
- Antiquated, defective, and improper mortgage servicing practices; and,
- Investors lack effective legal remedies for violations of RMBS contractual obligations and other rights arising under state and federal law.

I. Background

The AMI was formed to become the primary trade association representing investors in mortgage-backed securities (MBS), along with life insurance companies, state pension and retirement systems, university endowments, and pension funds. It has developed a set of policy priorities that we believe can contribute to achieving this goal. We were founded to play a primary role in the analysis, development, and implementation of mortgage and housing policy that keep homeowners in their homes and provide a sound framework that promotes continued home purchasing. In practice, only three sources of residential mortgage capital exist in the United States: (1) the bank balance sheets- which are arguably full and stressed; (2) the government (Fannie Mae, Freddie Mac, FHA); and, finally, (3) securitization, which is effectively shutdown for the reasons described herein.

Today's U.S. mortgage market consists of approximately $11 trillion in outstanding mortgages. Of that $11 trillion, approximately one-half -- $5.4 trillion -- are held on the books of the GSEs as agency mortgage-backed securities (issued by one of the agencies) or in whole loan form. Another $4.0 trillion are on the bank balance sheets as whole loans or securities in their portfolios, of which $1 trillion are second liens (*i.e.*, home equity loans/lines of credit or closed end second mortgages).[1] Of the $1.1 trillion outstanding second mortgages, only 3.7% of the total (or $41 billion) is held by private investors in securitized form. The remaining $1.2 trillion in first lien mortgages reside in private label mortgage-backed securities (MBS). AMI's members hold a significant proportion of these investments; AMI members have approximately $300 billion of assets under management.

The development of enhanced structures, standards, and safeguards will contribute to improving the functioning of capital markets for all investment asset classes, especially those pertaining to a necessity of

[1] Observers note that while PLS represents approximately 12.8 percent of the first lien market, they represent 40% of the loans that are currently 60+ days delinquent.

life, namely housing. Your work will contribute to helping to keep Americans in their homes, making credit available, and the development of effective tools against the foreclosure crisis.

Mortgage investors share your frustration with the slow restoration of the housing market, relief for homeowners, and finally offering the capital markets and homeowners that are truly in need meaningful and permanent relief. In fact, the markets for Residential Mortgage Backed Securities (RMBS) securitization have virtually ground to a halt since the financial crisis for reasons that we will enumerate.[2] We are hopeful that meaningful solutions can be implemented more quickly, and we believe that our interests are aligned with responsible homeowners. As difficult as it may be to believe, many of the most sophisticated investors were as victimized and abused by the servicers and their affiliates as were many consumers. Investors are essential in order to rebuild the private mortgage market. However, investors and their private capital will only return to a market which is transparent, has non-conflicted stakeholders, and the protection of contract law.

a. The Role of Mortgage Investors in the Marketplace

Mortgage investors, through securitization, have for decades contributed to the affordability of housing, making credit more inexpensive, and making other benefits available to consumers. Today, however, mortgage investors face enormous challenges in the capital markets due to opacity, an asymmetry of information, poor underwriting, conflicts-of -interests by key parties in the securitization process, as well as, the inability to enforce rights arising under contracts, securities and other laws. This list is by no means intended to be exhaustive. Accordingly, investors, average Americans, and the U.S. economy at-large are harmed.

[2] The exceptions are two recent securitizations by Redwood Trust.

b. The History and Rise of MBS Securitization

It is important to note that securitization as a mortgage finance tool has been instrumental in reducing housing costs and helping citizens achieve the American dream of homeownership. In the 1970s, the mortgage finance industry was in its infancy. In fact, then the market consisted solely of two products – those backed by Ginnie Mae and Freddie Mac. The advent of the mortgage-backed securities market resulted in de-regionalizing or nationalizing real estate investment risk, increasing liquidity to mortgage originators, and lowering barriers to home ownership. Securitization was a key factor in improving regional real estate markets. New York State is a case in point. In the 1970s, most New York depositories were flush with cash but had a hard interest rate limit on mortgages. The result was a flow of California mortgages to New York and a flow of dollars to California. New York was an unattractive and non-competitive local market. With securitization, the New York market, as well as other markets became national markets; and hence, mortgage funds were more readily available. Since the 1970s, mortgage-backed securities have increased lending levels, with even state housing agencies benefiting from the mortgage-backed securities' structuring techniques. The benefits of securitization are widely known.[3]

II. Mortgage Investors' Interests Align with Responsible Borrowers

Mortgage investors are aligned with both homeowners and the government in our shared goals of keeping responsible Americans in their homes and rebuilding and maintaining a vibrant real estate market. In fact, the maintenance of a healthy securitization market is a vital source of access to private capital for mortgages as well as autos and credit cards. Moreover, an efficient securitization market provides more and cheaper capital to originators, which allows them to issue more loans to additional qualified

[3] *See e.g., Securitization and Federal Regulation of Mortgages for Safety and Soundness,* CRS REPORT FOR CONGRESS at 2 (RS-22722, Oct. 21, 2008). ("This *securitization* of mortgages increased the supply of funds available for mortgage lending).

borrowers. The use of mortgage-backed securities equitably distributes risk in the mortgage finance industry, and prevents a build-up of specific geographic risk. These features, and many others, are those of a market which makes access to capital cheaper and thus spurs more mortgage lending.

Mortgage investors seek effective, long-term sustainable solutions for responsible homeowners seeking to stay in their homes. We are pleased to report that mortgage investors, primarily the first lien holders, do not object to modifications as part of a solution. Unfortunately, mortgage investors are often powerless under the operative Pooling and Servicing Agreements (PSA) to offer such support. We strive for additional remedies to assist homeowners. Likewise, if a borrower speculating in the housing market, engaging in a strategic default or paying only their second lien mortgages, then they should not be eligible for receiving subsidized first lien interest rates. Potential structural changes that should be examined include: full recourse, blockage of interest payments on second lien debt if the first lien is in default, prohibitions on the second lien debt above a specified loan-to-value (LTV).

Those "private label" (non-Federal agency) securities are put together by a variety of entities (*e.g.*, investment banks) that pool the mortgages into a trust. The trust is built around a document called a Pooling and Servicing Agreement (PSA) that provides investors the rights and protections relating to the mortgages that make up the securitization and the terms and duties that are owed to the investors by the trustee of the security and the servicer of the individual mortgages. Within this Agreement, numerous representations and warranties exist regarding the quality of the mortgages that are included in the trust and the lending practices that were followed in the mortgage origination process. It is important to note that, historically, investment in these mortgage products have been attractive, in part, because they are governed by binding contracts that lend the stability and to the predictability investors desire. Like any purchaser, investors expected the sellers of mortgage securities (which were often large banks) to stand behind their promises. Similarly, the GSEs, the Federal Reserve Bank of New York, and others confront the same challenges. Unfortunately, this critical component of mortgage securities market has broken down, harming mortgage investors including state pension and retirement systems.

With a restored, vital and healthy securities market, we will be able to attract more private capital into mortgage investments and, in turn, provide more affordable mortgages for potential qualified home buyers.

a. Problems Arising from Improper Servicing

As Congress reviews this area and considers solutions for enhancing securitization, it may wish to review solutions across all asset classes. We wish to highlight that the housing space and MBS have been devastated by the practices and events of the last few years. Accordingly, we urge lawmakers that it is necessary to treat MBS separately from other asset classes in an effort to restore the U.S. housing sector and help American families pursue home ownership. The problems impacting investors by the malfeasance of servicers and their affiliates are numerous. We wish to highlight the following points:

- **Many Servicers are Conflicted; They May not be Servicing Mortgages Properly.** Very often they are harming the interests' of both investors and homeowners' interests. This has a negative impact on private investor demand for mortgages and limits housing opportunities;[4]

- **Originators and Issuers May not be Honoring their Contractual Representations** about what they sold into securitizations. Additionally, the documents are vague, with basic terminology

[4] An example of this conflict is as follows. Consider the case when the servicer and the master servicer are the same entity. In such a case, a lack of effective oversight exists when the enforcement entity is owned by the same parent as the servicer. For example, in certain deals the Master Servicer has "default oversight" over the servicer therefore certain loss mitigation cannot be accomplished. Hence certain critics observe that when both are owned by the same parent entity, with the identical priorities and culture, no effective oversight is possible.

having no definite meaning (*e.g.*, delinquency or default). The past is prologue and there are no assurances that they will not repeat these practices in the future; and,

- **The Market in General Lacks Sufficient Tools for First Lien Mortgage Holders**, such as: recourse to the homeowner on a uniform, national basis (to avoid strategic defaults) and efficient ways to dismiss the 2nd lien (to allow for more effective workouts with the homeowner on the first lien).

III. Solutions offered by Mortgage Investors

The current legal and regulatory landscape presents numerous obstacles for the MBS securitization, including a lack of the necessary transparency for the effective functioning of capital markets in connection with several fundamental aspects of the system. These problems are varied and numerous in the RMBS context. For example, investors were offered transactions with overly complex legal documentation, obscured salient facts about a deal, and take-it-or-leave-it time frames for acceptances of offers to purchase securities in underwritings. The lack of transparency in this context distorted markets and ultimately proved to impair the health and stability of our housing and mortgage markets. In essence, mortgage investors simply seek the salient facts underlying a transaction. In fact, last week, Mr. Edward DeMarco, Acting Director, Federal Housing Finance Administration (FHFA), testified before a House of Representatives Subcommittee and explained the following:

> *FHFA views enhanced, loan-level disclosures as necessary for investors to analyze and assess the potential risks associated with the collateral of asset-backed securities, including mortgages.*[5]

[5] Hearing on *Transparency as an Alternative to the Federal Government's Regulation of Risk Retention*, before the House Oversight and Government Reform Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, May 11, 2011 (testimony of Acting Director Edward DeMarco).

Accordingly two sets of consequences have arisen. First, the U.S. private mortgage-backed securities market has ground to a halt. Observers note that with two exceptions, no new RMBS securitizations have occurred since the financial crisis. Second, Americans suffer through reduced credit, more expensive mortgage rates, and fewer housing opportunities. In an effort to solve the problems facing the capital markets and the working class, AMI has offered a number of policy solutions which are described in its *Reforming the Asset-Backed Securities Market White Paper* (March 2010).

We believe that the recommendations below, which are detailed in depth in the attached white paper, support healthy and efficient securitization and mortgage finance markets, with more information made more widely available to participants, regulators, and observers; incentivize positive economic behavior among market participants; reduce information asymmetries that distort markets and are entirely consistent with the government's traditional roles of standard-setting in capital markets. In sum, the AMI offers the following recommendations to enhance transparency and best securitization practices within capital markets:

- *Provide loan-level information that investors, ratings agencies and regulators can use to evaluate collateral and its expected economic performance, both at pool underwriting and continuously over the life of the securitization.*
- *Require a "cooling off period" when asset-backed securities are offered so that investors have sufficient time to review and analyze loan-level information before making investment decisions.*
- *Make deal documents for all asset-backed securities and structured finance securities publicly available to market participants and regulators sufficiently in advance of investor decisions whether to purchase securities offered.*
- *Develop, for each asset class, standard pooling and servicing agreements with model representations and warranties as a non-waivable industry minimum standard.*

- *Develop clear standard definitions for securitization markets.*
- *Directly address conflicts of interests of servicers that have economic interests adverse to those of investors, by imposing direct fiduciary duties to investors and/or mandatory separation of those economic interests, and standardize servicer accounting and reporting for restructuring, modification or work-out of collateral assets.*
- *Just as the Trust Indenture Act of 1939 requires the appointment of a suitably independent and qualified trustee to act for the benefit of holders of corporate debt securities, model securitization agreements must contain substantive provisions to protect asset-backed security holders.*
- *Asset-backed securities should be explicitly made subject to private right of action provisions of anti-fraud statutes in securities law and to appropriate Sarbanes-Oxley disclosures and controls.*
- *Certain asset-backed securities can be simplified and standardized so as to encourage increased trading in the secondary market on venues, such as exchanges, where trading prices are more visible to investors and regulators.*
- *Ratings agencies need to use loan-level data on their initial ratings and to update their assumptions and ratings as market conditions evolve and collateral performance is reported.*

IV. Conclusion

Mortgage investors believe that the vibrancy and effectiveness of the U.S. capital markets can be restored, in part, by enhancing the transparency around fundamental regulatory structures, standards, and systems. Toward this goal, the government has a role – not through the heavy-hand of big government, but rather, the light touch of a prudent standard-setter and facilitator. With appropriate standards and rights for the holders of asset-backed securities, securitization would achieve the goals sought by many – the more efficient funding of capital markets, lessening volatility, and the resulting better economic activity. In the absence of transparency, the future of the U.S. housing finance system will remain dark, hurting America's global competiveness and our domestic health. The results will include less home lending, more expensive credit, and fewer housing options and less opportunity for working class Americans. These are the reasons that we need solutions providing for more transparent systems and restarting our capital markets.

Thank you for the opportunity to share the views of the Association of Mortgage Investors with the Subcommittee. Please do not hesitate to use the AMI as a resource in your continued oversight concerning the many issues under review. We may be reached through AMI's Executive Director, Chris Katopis, at 202-327-8100 or by email at katopis@the-ami.org. We welcome any questions that you might have about securitization, representations and warranties, or other mortgage industry topics.

Written Statement of:

Ajay Rajadhyaksha, Managing Director, Barclays Capital

Before the United States House of Representatives

Committee on Financials Services

Subcommittee on Capital Markets and Government Sponsored Enterprises

"Facilitating Continued Investor Demand in the U.S. Mortgage Market Without a Government Guarantee"

September 7, 2011

BARCLAYS CAPITAL

BARCLAYS CAPITAL

Good Morning, Chairman Garrett, Ranking Member Waters, and other Members of the Subcommittee. I am Ajay Rajadhyaksha and I run US Fixed Income Research at Barclays Capital in New York, including research on housing finance and the mortgage markets. I appreciate the opportunity to discuss ways for the government to facilitate private investor demand in the US mortgage market.

The state of housing finance in the US, where government sponsored entities (GSEs) account for over 90 percent of all mortgage loans currently made, is problematic. We believe that there are several ways in which the government can help change this to encourage private sector issuance of mortgages. I have broken these proposals into three areas. The first is about how to incentivize the issuers and underwriters of private label MBS; the second is about making life easier for investors who will purchase private label MBS; and the third pertains to establishing a benchmark to help the private sector price mortgage credit.

1.) On the issuance front, there are three specific issues to address:

- Rationalize various regulatory regimes that mandate capital requirements.
    - Currently, certain regulatory regimes depend on ratings, such as the banking system. Meanwhile, others like the insurance industry regulator, National Association of Insurance Commissioners (NAIC), have moved to loss-based models that generate capital requirements. We believe that such industry-wide models are the better way to go than depending on a black box ratings approach.
    - Take into account the investors' cost-basis in the security as well as expected losses when mandating capital requirements.
- Reduce areas of legal uncertainty especially with regard to repo and warranty enforcement mechanisms and the enforceability/transferability of the related mortgage notes.
- Clarify rules around risk-retention and disclosures to reduce regulatory uncertainty. We also recommend that risk retention focus on the point at which the loan is originated, which is where the credit decision is truly made.

2.) There are also several steps that can be taken on the disclosure front to make private label MBS issuance more attractive to prospective investors.

- Create a transparent and timely way to enforce repo and warranties. In the private label transactions of the last decade, in several cases, investors had a hard time even getting access to the loan files unless they owned more than a majority of the deal. Transparency on this issue would help everyone -- investors, issuers and regulators.
- Legalize Mortgage Electronic Registration Systems (MERS) and streamline the legal process required to correctly transfer loans. Make this process uniform across states. This will remove uncertainty around the documentation related to proper ownership of these loans.

- Remove uncertainty around servicing by creating servicing standards that are similar to those needed by Federal Housing Association (FHA) and Federal Housing Financing Agency (FHFA).
- Mandate periodic release of standardized information about performance of servicers on loss-mitigation efforts across all loans that they service.
    - On a related note, mandate periodic release of standardized information on repurchase requests/ actual repurchases across all private deals for each securitizer/originator.

- Require the Securities Exchange Commission (SEC) to set up data format and quality standards for initial and ongoing disclosures for asset backed deals (as per Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and some additional issues). These standards should include:
    - Standards for initial disclosures including information on the loans/ the borrowers as well as information around risk-retention. Standards should also cover information on underwriting policies and practice.
    - Mandate that the deal waterfall model be made available to all current and potential investors in an easily usable manner such as an Index CDI. Any corrections made to this model should be publicly disseminated as well. Impose penalties on underwriters for incorrectly modeled securities.
    - Standards for ongoing disclosures at a loan level including information on payment behaviors, re-appraisals on delinquent borrowers, and on loss-mitigation actions taken.
    - Standards for ongoing disclosures at a deal level which mandate a standard format for remittance reports which clearly show the trust cash flows and the sources of the funds and the uses of those funds in paying out the bonds or any other obligations of the trust.
    - Standards for ongoing disclosures of rep and warranty breaches and repurchase information as well as lower barriers for access to information relevant to assessing breaches of reps and warranties.

Taken together, 1 and 2 should go a long way to reducing legal uncertainty, and providing greater transparency to investors. However, we are not convinced that this is enough to jumpstart private label mortgage issuance. Policy makers also need to make an effort to replicate the standardization and uniformity provided by the agency MBS market in one more way – by providing a benchmark that helps the private sector price mortgage credit, which I will discuss in the next section.

3.) For decades, the GSEs – specifically, Fannie Mae and Freddie Mac – have hedged their interest rate risk actively in the capital markets. But their bigger risk has always been the credit risk in the mortgages that they guarantee. And unfortunately, this was a risk that kept rising on the GSEs balance sheets every year, without being hedged, as the number of loans they were guaranteeing increased.

We recommend that the GSEs sell a portion of the credit risk in their existing guarantee business to the private sector. I will not go into the exact details of this process in the interests of time. But we believe implementing this process should be relatively easy, since it does not require additional Congressional action and the GSEs should already have the needed financial technology. Selling credit risk to the private sector would transfer some of the risk from the taxpayer to the private sector. But perhaps the single most important reason to sell GSE credit risk is to establish a benchmark against which the private sector can price mortgage credit.

What do we mean by that? Consider the 2009 4.5% MBS universe. These are loans guaranteed by Fannie Mae and Freddie Mac that were made in the year 2009 and securitized in the 4.5% coupon. There are more than $300 billion of these GSE guaranteed loans that have been outstanding for more than 2 years. This is a big cohort with a fair amount of uniformity. If the GSEs were to sell the credit risk in this pool to the private sector, it would create a considerably more active market for private mortgage credit. The uniformity, size of the cohort, and the available data of more than 2 years of credit performance would ensure that private sector investors have a benchmark. Such a benchmark, we believe, is important for an active secondary market for mortgage credit. And an active secondary market is in turn important for a return of primary issuance in private label mortgages. At the very least, investors would be able to have a better sense of, and more confidence about, what they should be paying for new purchases in the private label mortgage markets, encouraging primary issuance.

Finally, while I believe that the private label mortgage market needs to be responsible for a greater share of origination, I would caution policymakers to closely watch the pace of any such transition. The availability of mortgage credit is extremely important to the housing market, especially in its current vulnerable stage. Consider for example, the first half of 2007. The unemployment rate was still near 5%, and yet home prices started dropping. One reason was because as secondary market prices for non-agency MBS started falling, it became impossible to issue new loans in the primary markets for private label MBS. As a result, mortgage credit availability suddenly dropped, which in turn hurt housing demand. There were definitely other factors that contributed to the crash in home prices, but one catalyst was a sudden decline in the availability of mortgage credit. To avoid a repeat of this, I would remind policymakers that, even as they work towards increasing the involvement of the private sector in mortgage origination, the government will need to provide support to housing finance, at least in the near-term.

Chairman Garrett, Ranking Member Waters, and other Members of the Subcommittee, I thank you for your time and attention and the opportunity to present in front of this subcommittee.

Testimony of Joshua Rosner before the House of Representatives' Subcommittee on Capital Markets and Government Sponsored Enterprises.

Hearing: "Facilitating Continued Investor Demand in the U.S. Mortgage Market Without a Government Guarantee".

September 7, 2011

Thank you Chairman Garrett, Ranking Member Waters and members of the Capital Markets and Government Sponsored Enterprises Subcommittee for inviting me to testify on this important issue

Between 1989 and today, securitization markets, and therefore the capital markets, have replaced banks as the lead funding for home mortgages. It is true that excessive social engineering to over-stimulate housing purchase drove speculation. But in my view, poorly developed and opaque securitization markets drove excessive liquidity and irresponsible lending and borrowing. Without the confluence of these issues we would not have had the withdrawal of liquidity to the mortgage finance market and an ongoing cycle of falling home prices. This opacity is the actual root of the crisis, and it led to the ultimate breakdown of the private securitization market.

Today, as it was in the prelude to the crisis, securitization markets too often operate in a "Wild West" environment where the rules are more often opaque than clear, standards vary, and useful and timely disclosures of the performance of loan level collateral is hard to come by. Asymmetry of information, between buyer and seller, is the standard.

Current problems in the real economy, stemming from the opacity and information asymmetry of the asset backed securities (ABS) market, are not isolated to private first-lien residential mortgage securitization markets. However, because of the excessive degradation of mortgage underwriting standards and the growth in mortgage funding, we have seen the most serious damage in this sector. Consider the scale of this growth: between 1985 and 2007 the ABS market grew dramatically, from $1 billion in new issues to $997 billion in new issues[i].

To believe that real estate or the economy itself can find a self-sustaining recovery without first repairing this important tool of financial intermediation is unrealistic. Liquidity cannot efficiently find its intended target unless there are credible markets in which participants can foster financial intermediation and through which capital can be transmitted. Expanding the monetary base without an effective means of financial intermediation can result in little more than hoarding. Other than fostering new asset bubbles, it may have little sustainable productive economic impact.

<u>A Better Solution</u>

Nothing has been done to create industry standards or useful and timely disclosures of loan level collateral characteristics. Asymmetry of information between buyer and seller remains the standard. In fact, through the elimination of the Regulation Fair Disclosure exemption for rating agencies[ii], Dodd Frank has resulted in a reduction in the information available to investors.

The primary market for securitizations had been different from the equity markets. There was no "red herring" or pre-issuance road-show period during which investors had the ability to analyze a deal and its underlying collateral. Typically, deals came to market so quickly that investors were forced to rely on rating agency pre-issuance circulars, term-sheets or weighted average collateral data. These tools have proven inadequate[iii]. Moreover, with a lack of pre-issuance collateral disclosure standards deals usually came to market before the collateral pool was even complete. While this approach worked well in the "TBA" market that was a direct result of clear underwriting guidelines, credit boxes and servicing standards. Such standards did not exist outside the agency market.

The Need for Disclosure

To ensure adequate transparency in the non "TBA" market, data on the specific underlying collateral in each pool should be made available for a reasonable period (not less than 5 days) before a deal is sold and brought to market. Such a requirement would enhance investor due diligence, foster the development of independent analytical data providers, and to reduce reliance on rating agencies[iv]. It would also effectively reduce reliance on ratings and support a narrowing spread between price and value in the secondary market.

In the lead-up to the crisis, even primary financial regulators could not analyze or even have access to deal documents of CDOs their regulated institutions held[v]. The automation, standardization, and public disclosure of key collateral information before a securitization is marketed — and at least monthly thereafter, in an electronically manageable and standardized format, is a necessary ingredient to the development of the deep and broad markets necessary to fund our economy. Capital and markets would be less volatile if they could fully model the expected performance of underlying loan level collateral and regularly reassess the deviance from expectation.

Contracts that Work

"Pooling and Servicing Agreements" (PSAs) and "Representations and Warranties" can be several hundred pages long. They define features like the rights to put back loans that had underwriting flaws, the responsibilities of servicers and trustees, and the relationship between the different tranches.

We need to address the lack of uniformity in the contractual obligations between various parties to a securitization. Key terms that define contractual obligations are not standardized across the industry, across issuers of securities with the same type of collateral or even by issuer (each issuer often had several different Pooling and Servicing Agreements and Representation and Warranty Agreements).

The lack of standardization and the length of the documentation effectively created opacity, which contributed to the problems in the securitization market. When panic set in and investors began to question the value of their securities, they knew that they did not have the time to read all of the different several-hundred page deal agreements.

This reinforced the rush to liquidate positions and supported a "run on the market" that caused securities' values to fall further than fundamentals justified. After all, what investor would choose to be the last one holding a security whose terms are not easily understood?

Legislation should direct regulators to create a single standardized Pooling and Servicing Agreement governing each collateral asset class whether the issued securities are registered or "over the counter" or "bespoke". These agreements should be created with the best interests of the investing public, and clarity of contract, at their cores.

Why Standards Matter

Legislative and regulatory standard setters must also focus on addressing a lack of clear definitions in securitization markets. Without a common language and agreement on the meanings of fundamental concepts the value of data is diminished. Conversely, if everybody is using common language – in loan origination or securitization — then it becomes very hard to game the system.

Amazingly, three years after a crisis, there is still no single standard accounting or legal definition of either delinquency or default. Currently, the term 'delinquency' can be determined either on a contractual or recency-of-payment basis. Even among firms that would define it on the same basis, each servicing agreement can have different interpretations of the reporting of delinquencies. Some may report advances that a servicer makes to a pool, which could be applied to reduce stated delinquencies, other servicers may not. Like so many of the underlying problems in the securitization market, this "Wild West" mentality needs to be replaced with agreement of terms and standards.

While the conflicts inherent in the public/private corporate structure of Fannie Mae and Freddie Mac created significant distortions in the market and led to their ultimate failure there are real and valuable lessons the GSEs demonstrate. Investors can and will support a TBA market comprised of standardized securities composed of clearly defined collateral as long as there are adequate clear requirements and standards defining credit, documentation, pooling, servicing, representations and warranties. Going forward, and in absence of a government guarantee, the TBA market would require a gatekeeper to oversee and audit compliance with such standards.

True Sale

In recreating the structured market, we must also clear outstanding legal questions[vi][vii] about matters such as "true sale"[viii][ix]. Without clarifying the clear legal and accounting standards on "true sale", issuers of a securitization may retain rights to or responsibility for collateral that they thought they sold and the investor in a pool believed himself to have purchased.

Collateral Servicing and Fiduciary Obligations

When a pool of first lien mortgages is created and sold into a trust, a servicer is chosen to service the loans, collect the mortgage payments and direct the cash flows to investors as defined by agreement. While investors in different tranches to the securitization may not always have aligned interests, in light of the significant numbers of mortgages today that have negative equity most of the remaining holders would be willing to write down the principle balance of the loan if they would result in re-performance of collateral. For example, assume a 20% reduction in the principal balance of a mortgage would result in a borrower becoming willing and able to make payments and become current again, on a sustainable basis. This 20% loss, though significant, would surely be preferable to the potential 70%-plus loss investors could experience upon default and a subsequent foreclosure.

Unfortunately, due to an ill-defined legal relationship between service and investor, along with a large and common conflict of interest between the servicer and the affiliated companies that own most of the servicers, many servicers do not prefer this "less is better than nothing" approach. The largest servicers are owned by large banks -- banks that hold the majority of second liens and home equity lines on the underwater houses[x]. Remember, the second lien is, by definition, subordinated to the first lien. So if the servicer wrote down the principal on the first lien, it would, where the mortgagee is in a significant negative equity position, completely wipe out the value of the second lien and cause the bank to experience a total loss on that loan.

Because of the lack of a fiduciary obligation to the first lien holder, servicers are often motivated to protect their affiliated firm's second lien positions, rather than the first lien holders'. And because of the way the servicing agreements are written, servicers are often able to justify their inaction by hiding behind the disparate obligations they owe to investors in different tranches. Alternatively, they are able to do so by using a "net present value test" that is based on projections of unknowable future scenarios. As a result, both investors and the troubled borrower are held hostage to servicing practices that seek to protect often under-reserved banks rather than act on their expected obligation to investors in the mortgage pool. New rules in securitization should clearly define the servicer's obligations[xixii] and require a fiduciary duty to the investor in securitized pools. Perhaps, more effectively, legislation should specifically prohibit financial entities from owning servicing where the servicing results in a conflict[xiii].

Housing Policy is a Different Matter

Four years after the crisis began we have still not begun to have a real discussion about either housing policy or the recreation of the mortgage finance industry. These are two different subjects. To reduce the temptation of legislators to use private markets as tools of social policy, the structure of the mortgage finance industry must be separated from housing policy goals.

The government should not encourage aggressive use of debt finance. Financial crisis are much more likely occur in a society of highly leveraged borrowers. A high priority should be to shift any housing related subsidies from ones that encourage the aggressive use of debt to a system that supports the building of private equity. We should be seeking ways to credibly shift financial sector risk back to the private sector, not ways to formalize the government's exposure to that risk.

Until this crisis, and for most of the post war period, the government's social policy mission to increasing ownership was achieved through direct and on budget programs. These programs which had been effectively delivered through the VA's GI Bill, through Ginnie Mae and through Farmer Mac became less meaningful as broader subsidies, delivered through private capital markets and the tax code, created broader subsidies to be delivered through private market players. To the degree that social policy dictates a need for housing subsidies to be delivered to particular segments of society there are more efficient and effective tools that would be less susceptible to private market arbitrage.

Remember, the historic virtues of homeownership were conferred as a result of homeownerships' historically unique place as a forced savings plan, where borrowers made monthly payments of principal and interest into an illiquid asset such that, by about the time of retirement, the borrower had unencumbered ownership of their largest retirement and intergenerational wealth-transfer asset.

Ownership, in this manner, reduced retiree demands on the social safety net programs of the Federal Government such as social security, Medicare, Medicaid and reduced reliance on public sector pensions. This prior world of ownership, through increasing personal savings in that discreet asset, was gutted by a tax code that, through the Mortgage Interest Deduction, supported the extraction of savings.

The mortgage interest deduction only benefits those mortgagees who are wealthy enough to itemize their taxes. As a result it supports borrowers least in need of government support. I would propose that we grandfather existing mortgages that have the mortgage interest deduction but replace it with a new and more purposeful and efficient program going forward.

There is merit in consideration of a tax-free "housing personal savings account" similar to a Health Savings Account or 529 account. Such accounts could be used for the future housing expenses of first-time homebuyers or first-time renters. Any excess in the accounts above the amount used for a down payment or initial rental fees could be used for future reductions in principal balances or rental payments.

We might also consider replacing the mortgage interest deduction with an "equity principal tax credit" for future mortgage originations. The credit could target the most underserved households with a subsidy or tax credit based on the yearly reduction in mortgage principal balance. As a result, for targeted borrower groups, a 20% down payment would result in an immediate credit of a portion of that payment. The credit would phase out based on borrower incomes. To ensure the building of home equity, benefitting borrowers would not be permitted to extract equity or place further encumbrances on the home, such as a second lien. A similar strategy could be used as incentive for selected borrower groups, who are within a decade of retirement age, to pay build equity as quickly as possible. This would reduce demands on The Treasury's social safety net programs.

Such programs would reduce the need for subsidies to be delivered through the mortgage finance system. Furthermore, although they would require increased modeling of prepayment risk, they would reduce credit risk and also reliance on the 30-year mortgage product.

Conclusion

The hope is that the original promise of securitization, through which banks could originate quality loans and sell them to investors who would be better able to hold the risks of those assets, can be realized. This would free up bank balance sheets to make more loans in support of financial intermediation and economic expansion.

[i] Josh Rosner "Securitization: Taming the Wild West", Roosevelt Institute Conference, March 3, 2010 available at: http://makemarketsbemarkets.org/modals/report_securitization.php
[ii] http://www.sec.gov/rules/final/2010/33-9146.pdf

[iii] Rosner, Josh and Joseph R. Mason, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions (May 3, 2007), at 84 [available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027475](The potential for prolonged economic difficulties that also interfere with home ownership in the United States raises significant public policy concerns. Already we are witnessing restructurings and layoffs at top financial institutions. More importantly, however, is the need to provide stable funding sources for economic growth. ***The biggest obstacle that we have identified is lack of transparency. The structural changes noted in our previous draft largely went unnoticed by RMBS investors until only recently. We argue that those changes went unnoticed largely because of the existing complexity and valuation difficulties underlying today's RMBS markets.*** But policymakers and ratings agencies are still reluctant to examine some of the key frictions that have caused the present mortgage mess And there is still no focus on monitoring bank-funding markets. The feared outcome is nothing less than a 21st century bank run, this time from CDO investors rather than depositors".) [Hereinafter Rosner and Mason May 2007].

[iv] Rosner, Joshua, Toward an Understanding: NRSRO Failings in Structured Ratings and Discreet Recommendations to Address Agency Conflicts (Winter 2009). Journal of Structured Finance, Winter 2009. Available at SSRN: http://ssrn.com/abstract=1354608

[v] See Joseph R. Mason & Joshua Rosner, How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?, Working Paper, Feb. 15, 2007 p.36 (See: Perhaps of greater concern is the reputational risk posed to the U.S. capital markets—markets that have historically been viewed as among the most transparent, efficient, and well regulated in the world. The economic value of mortgage securitization and the risk transfer value of CDO issuance support their further use. However, there should be significant resources allocated to building the regulatory framework surrounding their structuring, issuance, ratings, sales, and valuation. We believe that efforts to provide transparency to these new product areas can foster stability while maintaining liquidity to the underlying collateral sectors and supporting further meaningful financial innovation and capital deepening. At present, even financial regulators are hampered by the opacity of over- the-counter CDO and MBS markets, where only "qualified investors" may peruse the deal documents and performance reports. Currently none of the bank regulatory agencies (OCC, Federal Reserve, or FDIC) are deemed "qualified investors." Even after that designation, however, those regulators must receive permission from each issuer to view their deal performance data and prospectus' in order to monitor the sector.)

[vi] Lois R. Lupica, Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic, 9 Am. Bankruptcy Inst. L. Rev. 287, 293 (noting that asset backed securities have grown from a relatively insignificant $1 billion market in 1985).

[vii] See, e.g., Jessica L. Debruin, Recent Developments in and Legal Implications of Accounting for Securitizations, 56 N.Y.U. Ann. Surv. Am. L. 367, 382 (1999), available at: http://www1.law.nyu.edu/pubs/annualsurvey/documents/56%20N.Y.U.%20Ann.%20Surv.%20Am.%20L.%20367%20(1999).pdf ("The Tenth Circuit in particular has been highly criticized, though not yet reversed, for its decision in a case involving true-sale analysis. Faced with a sale of accounts, the court in Octagon Gas Systems, Inc. v. Rimmer applied the provisions of Article 9 of the UCC to determine that the transaction constituted a security interest rather than a true sale.").

[viii] See, e.g BMeyer, Countrywide Mortgage settles with Ohio, 7 others, Oct. 6, 2008, available at: http://www.cleveland.com/nation/index.ssf/2008/10/countrywide_mortgage_settles_w.html (Author's note: If the Company has the right to enter into a settlement, for its benefit, and make commitments of third party investors in a supposedly legally isolated Trust, then it appears this action may again open the unresolved legal question of whether a securitization could ever be legally treated as a "true sale" as opposed to a disguised financing.)

[ix] Mason & Rosner May 2007 at 33 (see: "In December 2000, LTV Steel filed for voluntary Bankruptcy protection under Chapter 11 in the US Bankruptcy Court of Northern Ohio. ***In their filing the Company asked the court to grant an emergency motion to allow them to use the collections from the securitizations and claimed that the transactions were not "true sales" but rather "disguised financings". The Court granted the Company's motion though it did not rule whether or not the securitizations were "true sales"***. Although this case could have caused the rating agencies to take the same position as the Georgia law, of ambiguity making it difficult to rate the risks to noteholders they chose not to. In fact, one of the agencies appeared to pressure attorneys to avoid commenting on the matter in legal opinions. "Standard & Poor's insisted that attorneys submitting true-sale opinions to the rating agency stop referring to LTV, noting that the court never made a final decision and that such citations inappropriately cast doubt on the opinion. Seven months later, in a delicately worded press release, S&P withdrew that prohibition—apparently because lawyers refused to ignore such an obvious legal land mine".)

[x] Data available at http://www2.fdic.gov/sdi/

[xi] "OPEN LETTER TO U.S. REGULATORS REGARDINGNATIONAL LOAN SERVICING STANDARDS", December 21, 2010 available at: http://www.scribd.com/doc/45723130/Securitization-Standards-Letter

[xii] Representatives' Comment Letter to the Securities and Exchange Commission – December 22, 2010 http://www.sec.gov/comments/df-title-ix/asset-backed-securities/assetbackedsecurities-43.pdf

[xiii] H.R. 4953--111th Congress: Mortgage Servicing Conflict Elimination Act of 2010."
GovTrack.us (database of federal legislation). 2010. March 28, 2011
<http://www.govtrack.us/congress/bill.xpd?bill=h111-4953 >