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Before the

U.S. House of Representatives Committee on Financial Services

Subcommittee on Capital Markets and Government Sponsored Enterprises

TOPIC— Investor Protection: The Need to Protect Investors From the Government

Chairman Garrett, Ranking Member Waters, and Members of the Subcommittee, I thank you for your invitation to testify today. My name is Laurie Goodman, and I am a Senior Managing Director at Amherst Securities Group, L.P., which is a leading broker/dealer specializing in the trading of residential and commercial mortgage-backed securities. We are a market maker in these securities, dealing with an institutional account base; that includes financial institutions, money managers, insurance companies and hedge funds. I am in charge of our firm's Strategy function. Our group performs extensive, data-intensive studies to keep ourselves and our customers informed on critical trends in the mortgage-backed securities market.

I have been asked to testify today on behalf of the Association of Institutional INVESTORS, a very important subgroup of our customer base. The members of this Association are some of the oldest, largest and most trusted federally registered investment advisory firms in the U.S. Collectively, the members of the Association of Institutional INVESTORS manage ERISA pension, 401(k), mutual funds and personal investments on behalf of more than 100 million American workers and retirees. The asset managers that comprise the Association are long term investors whose holdings reflect the patient capital of their beneficiaries, and they have a fiduciary duty to the organizations and individuals whose money they manage. Thus, the concerns raised here today are not just the concerns of a group of institutional investors, but they reflect the concerns of and impact on the more than 100 million individuals they ultimately serve.

I will focus on the mortgage market, where institutional investors are a critical group of stake holders. As we try to bring private capital back into the mortgage market, this group will ultimately bear the risk. A disregard for the interests of these institutional investors will impact the cost and willingness of their participation in the mortgage market going forward. I discuss 3 specific topics where the government has taken actions *not* in the interests of investors, without even giving investors a seat at the table. The most recent is the State Attorneys' General Settlement with mortgage servicers, which I will dwell on at some length. In addition, I bring up 2 other topics where the government has wrongly harmed investors—the treatment of second liens in mortgage modifications (where lien priority is violated), and the unwillingness of the government to recognize that the costs of delays in the foreclosure process are borne by investors, not the banks/servicers that created them. I will take each of these points in turn.

I. The State Attorneys General Settlement

This settlement, between the State Attorneys General (AGs) and the 5 largest servicers (Bank of America Corporation, J.P. Morgan Chase & Co., Wells Fargo & Co., Citicorp, Inc., and Ally Financial, Inc.), with the heavy involvement of the Departments of Justice, Treasury, and Housing and Urban Development (HUD), was finalized in March 2012. This settlement was initiated in response to the use of "robo-signed" affidavits in foreclosure proceedings across the country.

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It resulted in approximately $25 billion in monetary sanctions and fines: $5 billion in cash to the general and state governments, with the remaining $20 billion to be used for relief to borrowers. Of that $20 billion, at least $10 billion must be dedicated to reducing principal for borrowers who owe more than their home was worth, and are either delinquent or at risk of default. At least $3 billion must be dedicated to a refinancing program for borrowers who are current on their mortgages, but owe more than their home is worth. The remaining amount, up to $7 billion, must be dedicated to other forms of relief, including forbearance of principal for unemployed borrowers, anti-blight programs, short sales and transitional assistance, benefits for members of the armed forces, and other programs.

***Note that the largest chunk of the assistance, at least $10 billion, is dedicated to principal reductions*.** The relief is tallied using a series of credits. If the bank/servicer does a principal reduction on a first lien loan in its own portfolio, under the terms of the AG settlement, the servicer "earns" $1 credit toward the settlement for each $1 written down. For loans in private label securitizations, which the institutions/servicers do not own, the servicers earn a $0.45 credit for each $1 written down. The servicers are required to complete 75% of their customer relief obligations within 2 years, and 100% within 3 years. There are additional incentives to relief provided within the first 12 months, and additional cash payments required from any servicer failing to meet its obligations within 3 years. We expect the AG settlement will dramatically increase the use of principal reductions by the affected servicers.

And while the most immediate effect will be on portfolio loans owned by the banks, we also expect an impact on loans in private label securities, including those owned by members of the Association of Institutional INVESTORS. ***Yes . . . the settlement banks can use modifications on loans owned by others to pay for their wrongdoings*.**

We believe principal reduction is the most effective form of modification, and we are thrilled to see greater use of this modification tool. However, the Association of Institutional INVESTORS is greatly concerned about the potential for abuse—if the affected servicers are unable to economically *modify* sufficient *portfolio* loans to meet their targets, they might choose to aggressively write down principal on *investors'* loans (e.g. do a larger modification when a smaller one would have been more economically reasonable). It has been argued that the so-called Net Present Value (NPV) test limits the potential for this abuse. Using the Treasury NPV test, as HUD has indicated will be the case, (rather than a less rigorous test designed by the servicers themselves), will certainly help, but does not eliminate the problem. The NPV test requires only that the Net Present Value on the modified loans be slightly better than the proceeds from liquidation; it does not require the servicer to pick the modification that produces the maximum NPV of each loan. It also does not require that the modification be superior to other pre-foreclosure workouts (e.g. temporary hardship payment plan, deed-for lease, FHA short refi, short sale). We would hope that the settlements are closely monitored so that servicers are unable to abuse investor funds to meet their target.

We recognize that the settlement is done; a *fait accompli*. At this point, speaking on behalf of the Association of Institutional INVESTORS, we have three pragmatic requests:

1) Since the settlement is being monitored by the very capable Joseph A. Smith, Jr., we hope he would persuade the banks to at least, provide investors with information on modification activity on private label securities undertaken under the settlement. More detailed loan-by-loan information is preferable, but we would, at the minimum, want to see aggregated information that allows us to look at, on a servicer by servicer basis by mortgage loan ownership (bank portfolio versus securitization) and lien type (first versus second):

    - number of loans modified
    - outstanding balance of loans modified
    - principal reduction percentage
    - percentage of investor loan modifications that followed HAMP standards
    - percentage of investor loans in which the bank owned the second lien
    - average principal reduction amount and percentage on such second liens

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The Association of Institutional INVESTORS has detailed these requests in a separate white paper attached as Appendix A. If banks truly intend to avoid using reductions on private investor loans to meet their required settlement credits, providing this information should not prove much of a burden. And it would provide an easily installed and important transparency for investors.

2) We request that, going forward, banks/servicers be unable to use investor money to settle charges of bank/servicer wrongdoings. We understand that there is discussion on other mortgage settlements, and want to ensure that the AG settlement, with banks/servicers permitted to pay with investor funds, does not become the blueprint for future settlements. We applaud Congressman Garrett's amendment to the Department of Justice (DOJ) Appropriations bill, which would ensure that any future agreement or future expansion of the National Mortgage Agreement protect the interests of investors, both by guaranteeing that investors participate and have a "seat at the table" in any future settlement negotiations, and by preventing servicers from receiving "credit" for their own wrongdoings via spending investor funds. We are very supportive of settlement agreements that treat borrowers fairly through the foreclosure process, and hold servicers accountable; but clearly, investors' contractual rights need to be respected.

3) Finally, for almost zero cost, this settlement could have provided some investor protection in the loan servicing process, via adequate disclosure on fees charged, but it did not. Our proposed protections would be easy to incorporate, even at this late time. The settlement documents require that the mortgage servicers implement new, borrower-friendly servicing standards. These new standards are designed to prevent mortgage servicers from engaging in robo-signing and other improper foreclosure practices; require banks to offer loss mitigation alternatives to borrowers before pursuing foreclosure; increase transparency of the loss mitigation process by providing borrowers more information regarding why they were turned down for modification or short sale; impose timelines to respond to borrowers; and restrict "dual tracking" (where a foreclosure is initiated despite the borrower's engagement in the loss mitigation process). It also provides more transparency on servicing fees and costs, including requiring that all default, foreclosure fees and bankruptcy-related services (including third-party fees) be *bona fide*, reasonable in amount, with detailed disclosure to the borrower. The problem is that nothing requires these fees be disclosed to the investor. This is a large issue for investors, who are effectively paying for these fees by allowing the servicer to net them for loan proceeds. And the potential for abuse is present, as some banks/servicers may own pieces of the foreclosure process. These services include force-placed insurance and property preservation (maintenance services, as well as property inspection services). Furthermore, even when a servicer is not affiliated with the company providing the property preservation activity, the servicer could mark up the fee considerably, and pass the cost along to the private label trust. Shouldn't investors, who ultimately pay these fees through a lower recovery on their loans, have the right to disclosure about these costs? A provision to provide investors the same disclosures as the borrower could have been established at a low marginal cost, and would have been if investors had a seat at the table. We hope that banks would voluntarily agree to this disclosure.

II. Second Liens, and Lien Priority

When investors initially purchased private label securitizations, they had assumed that lien priority would be respected. In the past, when loans defaulted, they were generally liquidated with the first lien holder receiving all the proceeds up to the limit of the original loan, as lien priority would dictate. While loan modifications on this scale were never contemplated, it was natural for investors to assume the second (subordinate) lien would be written off, or at the minimum, curtailed sharply, before the first lien suffered any diminution of cash flows.

Among non-performing borrowers whose loans are in private label securities, a sizeable 31% have second liens. Those second liens are often held in a bank portfolio, and most commonly, that same bank is also servicing the first lien. Of the $873 billion in home equity lines of credit and closed-end second liens, a whopping 92% is held by depository institutions. Of that, $656 billion (or 75%) is held on the balance sheets of commercial banks (including $370 billion on the balance sheets of the 4 largest banks, all party to the AG Settlement), while another $151 billion (17%) is held by non-bank depository institutions (credit unions and savings institutions).

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Owning the second lien while servicing both the first and second liens poses obvious conflicts of interest when the borrower runs into financial difficulty and the loans must be modified. Modifying the first lien increases the value of the second lien. Imagine the surprise to investors when the first version of HAMP was announced and the first lien was the only item modified. Once again, the original modification plan was designed by Treasury, with input from the largest servicers but no input from investors. That is despite the fact that investors in private label securities represent 12% of outstanding first lien loan balances but 38% of the 60+ delinquent loans.

In response to investor outrage, Treasury introduced the 2MP program, a second lien modification program. If a HAMP modification is done on the first lien, the second lien receives the same treatment. So if the interest rate is reduced on the first lien, the interest rate is also reduced on the second lien. If principal is forborne on the first lien, principal is also forborne to the same extent on the second lien. If principal is forgiven on the first lien, principal is forgiven to the same extent on the second. In other words, on a HAMP modification, the first and second liens are essentially treated *pari passu*. But since banks have a safe harbor for modifications done consistent with the HAMP framework, investors have no ability to appeal, and are thus totally at the mercy of the conflicted servicer who is making the decisions on investor-owned assets.

Note that in the AG settlement, the same *pari passu* treatment applies. If the first lien in a private label securitization is written down and credit is taken toward the settlement, the second lien must be written down proportionately. And investors were told they should be grateful for that treatment—in proprietary modifications, if the first was modified, it was unnecessary to impair the second at all.

Even the bank examiners condoned behavior in which banks/servicers modified the first mortgage and took no action on the second mortgage. It is only recently that banks have been required to take an impairment charge for performing second liens secured by the same property backing a non-performing or modified first lien.

Note that there was no attempt, at any point in the development of the modification process, to enforce the legal contract of lien priority.

III. Cost to Investors of Delays in Foreclosure Processes

Neither borrowers nor investors want to see foreclosures, it is the worst option for both—the borrower is removed from their home, and the investor receives a low recovery. Quick resolution is in everyone's interest. For example, modification success is an order of magnitude higher if modifications are done early in the delinquency process. There is no reason that over 40% of modifications occur on loans that are more than 12 months delinquent. However, some foreclosures are inevitable. There needs to be a recognition that the long delays in the foreclosure process, aggravated by government policies, are detrimental to both borrowers and investors.

The average loan in a private label security is 26 months delinquent at liquidation. On average, recently liquidated loan have spent 16 months in a delinquent state, then 7 months in foreclosure, and another 3 months in REO (the "real estate owned" asset category of banks). And these metrics just cover loans with completed liquidations. The delinquency timelines are apt to be longer for seriously delinquent loans that have not yet liquidated; this category disproportionately contains loans in judicial states, where liquidation takes longer. To put these numbers into context—3 years ago the average loan was 16 months delinquent at liquidation; today that number painfully draws out to 26 months. The entire difference is the time spent in delinquency (the period prior to foreclosure filing)—that ran 6 months in 2009, but has now stretched to 16 months. The time in foreclosure + REO has been constant at 10 months.

There is a real cost to these delays, and it is one that hits investors' pockets. If a borrower is not paying, the lender must continue to make the tax and insurance payments (and if force-placed insurance is used, the insurance payments can be quite large). Moreover there is an additional cost, one that we call "excess deprecation". Each day a home is either occupied by a non-paying borrower, or that home is not occupied, someone must pay to maintain it. If it is not being maintained, it will sell for less at liquidation. Based on a detailed loan level severity model, Amherst Securities estimates that these costs total approximately 0.5% of the value of the property per month (or 6% per year).

The foreclosure timeline has been extended in part because servicers have struggled with implementation of the HAMP modification programs (they could not efficiently gather and process the documentation needed for a modification). But

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when servicers finally instituted the systems to gather and process documentation, the robo-signing issue emerged. The remedial efforts further extended timelines and delayed foreclosures. Bank/servicers then had to go back and perfect the chain of title before they could foreclose on a property. We believe that the chain of title should be established prior to foreclosure. It is, and always has been, the responsibility of the servicers to make that happen. But the costs of these delays have been at investors' expense; they should accurately have been charged to the account of the banks/servicers who had the original and ongoing responsibility.

Conclusion

These 3 instances of government intervention harming investors stemmed from well intentioned actions to keep borrowers in their homes through foreclosure prevention. However, foreclosure prevention should be done by banks/servicers as a matter of course, to maximize the net present value of the loans. In fact, the interests of borrowers and investors are totally aligned—the net present value of a loan is maximized when the borrower is successfully modified (as the costs of foreclosure are huge; so avoiding that helps everyone).

In the AG settlement, the government is allowing banks to use investor funds to pay for their own wrongdoings. In the case of second liens, the government has ignored the lien priority issue, as well as the inherent conflicts of interest between the first lien holder and the bank/servicer who is also the second lien holder. In the third instance, the government has required banks to perform their contractual duty, which is to maximize the net present value of the loans. However, the banks/servicers are ill-equipped to take these actions, and the costs of the delays are being borne not by the offending institutions, but by investors.

Members of the Association of Institutional INVESTORS have a fiduciary duty to the organizations and individuals whose money they manage to ensure that the risks of investments are understood and priced accordingly. Governmental realignment of the risks of investment will force institutional asset managers to either: 1) demand higher returns for those risks in future investments, which will ultimately result in higher mortgage rates for loans where private capital is taking the credit risk, or 2) redirect investable funds away from those assets, which also has consequences. It is therefore important that the government address these concerns and explicitly acknowledge the role of investors as a very important group of stakeholders in the mortgage market.

I appreciate the opportunity to share the Association of Institutional INVESTORS' views on this critical issue and would be happy to answer any questions the Subcommittee may have.

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Discussion Paper:

Recommendations of Reporting Metrics To Be Required By Settlement Participants To Assist the Independent Settlement Monitor In Successfully Overseeing the AG Settlement's Implementation

Submitted by the:

Association of Institutional INVESTORS

May 3, 2012

OVERVIEW

The Association of Institutional INVESTORS[1] believes it is important for taxpayers, homeowners, and financial market participants to have the ability to see exactly how the five large servicers are meeting their obligations under the agreement. Accountability and transparency are particularly important because each bank faces a clear conflict of interest in how it directs principal reduction modifications – writing down principal on loans owned by the bank is likely less economically attractive than writing down loans owned by other investors. Additionally, banks often hold second lien mortgages in situations where other investors hold the first lien, but the banks service the loan. In such cases, writing down the first lien owned by other investors but keeping their own second lien in place further benefits the bank at the expense of other investors..

KEEPING THE BANKS ACCOUNTABLE

Given these concerns, The Association of Institutional INVESTORS suggests that the Independent AG Settlement Monitor requests a complete report from the five large servicers that focuses on the following principles:

- **Provision of Specific Information Provided by Each Bank Seperately On Steps Taken to Meet Obligations:** The independent monitor, and ultimately financial market participants, should be able to see how each institution is meeting its obligations under the agreement
- **Require Reports on a Monthly Cycle:** Given that the banks only have 12 months to complete the modification process, quarterly reporting would be insufficient. Under a quarterly reporting system, it would take two reports simply to confirm whether the banks are following the agreement. At that time, there would be less than six months would be left to make any changes
- **Disclosure of the Opportunity Set of Loans Considered for Modification:** Banks should disclose both the entire opportunity set of loans that could be reviewed and the opportunity set of loans that were considered each month before the bank decided which loans to modify. This information would ensure that banks are not simply focusing on potential loan modifications for loans in non-agency MBS transactions, but rather are also considering loans in the bank's owned portfolio as well.
- **Require a Break Down of the Modifications by Loan Owner and Lien Position:** It is imperative that the monitor require the banks to break down which loans are receiving a

[1] The Association of Institutional INVESTORS is an association of some of the oldest, largest, and most trusted investment advisers in the United States. Our clients are primarily institutional investment entities that serve the interests of individual investors through public and private pension plans, foundations, and registered investment companies. Collectively, our member firms manage ERISA pension, 401(k), mutual fund, and personal investments on behalf of more than 100 million American workers and retirees. Our clients rely on us to prudently manage participants' retirements, savings, and investments. This reliance is built, in part, upon the fiduciary duty owed to these organizations and individuals. We recognize the significance of this role, and our comments are intended to reflect not just the concerns of the Association, but also the concerns of the companies, labor unions, municipalities, families, and individuals we ultimately serve.

modification. Metrics should include whether the loan is bank-owned first lien, bank-owned second lien, investor owned first lien without a bank-owned second lien, or investor-owned first lien with a bank-owned second lien

- **Track What Percent of Modifications are Following Government-Prescribed HAMP Guidelines:** Based on our conversations with HUD, it is our understanding that 100% of investor loans modified are supposed to follow HAMP guidelines, but banks may have a strong incentive to use less rigorous modification methods for investor loans to reduce the need to modify bank-owned loans.

DATA REQUIREMENTS

Data can be provided in one of two forms: loan-level (each loan laid out separately) or as a comprehensive summary. The Association of Institutional INVESTORS' believes that loan-level data will allow the independent monitor to more effectively monitor the banks to ensure that the banks are following the settlement agreement. This requirement would be similar to the loan-level data that HUD and the Treasury Department receive for all HAMP modifications to ensure that the banks are compliant with the HAMP program. The Association of Institutional INVESTORS' members would appreciate the opportunity to see the loan-level data. Should it be determined that some of this information should remain confidential, summary tables on the data would still provide some useful information to investors to assist market participants in understanding whether banks are acting properly.

Additionally, we also believe it is important that the independent monitor have access to the bank's methods and formulas for loan modifications. These formulas will be invaluable in ensuring that each bank operates clearly within the confines of the language and spirit of the AG Settlement and will address conflict of interest inherent in how the bank directs the principal reduction modifications.

Loan-Level Information that Banks Should be Required to Report Monthly Should Include the Following Information:

- Number of Loans Modified
- Outstanding Balance of Loans Modified
- Principal Reduction Percentage
- Percentage of Investor Modifications that Followed HAMP Standards
- Percentage of Investor Loans in which the Bank Owned the Second Lien and Average Principal Reduction on such Second Liens
- Unpaid Principal Balance of the Loan (UPB)
- Delinquency Status Before the Modification (*i.e.* Current, 30-day delinquent, etc)
- Borrower State
- Origination Date
- Borrower Interest Rate Before the Modification

- Borrower Payment Before the Modification
- Borrower Rate After the Modification
- Borrower Payment After the Modification
- Borrower Principal Reduction as a Result of the Modification
- Home Appraisal Value
- Borrower Loan-to-Value Before the Modification (for 1st Lien Only)
- Borrower Loan-to-Value After the Modification (for 1st Lien Only)
- Borrower Combined Loan-to-Value Before the Modification (All Liens)
- Borrower Combined Loan-to-Value After the Modification (All Liens)
- Gross Principal Forgiven (Forgiven Late Fees, Penalties, Capitalized Interest, and Change in UPB)
- Owner of Mortgage (Bank vs. Investor)
- Total Debt-to-Income Ratio, Including All Consumer Debts (Pre/Post Origination of Subject Mortgage) and All Subordinate Mortgage Liens (at Time of Origination of Subject Mortgage and Subsequent to its Origination)
- Whether the Bank has an Economic Interest in the Second Lien on the Loan
- The Borrower's Residual Income (Pre/Post Modification) (*i.e.* How much does the borrower pay on cell phone coverage? Cable? Restaurants? Entertainment?)
- Time to Complete Modification (from First Solicitation through First Modified Payment)

Banks Should Also Be Required to Report to the Independent Monitor:

- Their Method for Establishing Current Marked-to-Market Loan-to-Value Ratio
    - Broker's Price Option (As is or Quick Sale/With or Without Marketing Time)
    - Automated Valuation Model
    - Appraisal
    - Whose Cost?
- The Net Present Value Test Formula and Inputs
    - Re-Default Rate – Timeframe (e.g. 1 year, 2 years, 5 years, or other)
    - Discount Rate
    - Forward House-Price Index
- Re-Defaults Rates on Principal Modifications Made Under the Settlement and the Total Severity of the Re-Defaulted Modification versus Forgone Recovery if Liquidated at Time of the Modification

At a Minimum, We Request that there be Public Disclosure of Summary Information in the Following Categories, Broken Down by Loan Owner and Lien:

- Number of Loans Modified
- Outstanding Balance of Loans Modified
- Principal Reduction Percentage
- Percentage of Investor Modifications that Followed HAMP Standards
- Percentage of Investor Loans in which the Bank Owned the Second Lien and Average Principal Reduction on such Second Liens

SAMPLE REPORTS

Bank Level

Bank	Portfolio Loans (2nd Liens)			Portfolio Loans (1st Liens)			Investor Loans			% of Investor Modifications that followed HAMP Standards	% of Investor Loans where Bank Owns 2nd Liens	Average Principal Reduction on Bank-Owned 2nd Liens Where the Investor Owns the 1st Lien
	# of Mod. Loans	Bal. before Mod.	Principal Reduction %	# of Mod. Loans	Bal. before Mod.	Principal Reduction %	# of Mod. Loans	Bal. before Mod.	Principal Reduction %			
Bank 1	15.00	2,670,000	15%	70.00	124,600,000	15%	40.0	12,800,000	25%	95.0%	10.0%	30%
Bank 2												
Bank 3												
Bank 4												
Bank 5												

Loan Level

Loan	Bank/ Servicer	Month Modified	Lien (1st or 2nd?)	DQ Status Before Mod.	Loan Bal. Before Mod.	Loan Bal. After Mod.	Rate Before Mod.	Payment Before Mod.	Payment After Mod.
Loan #1									
Loan #2									
Loan #3									
Loan #4									
Loan #5									

Principal Reduction Amount	Owner of Mortgage (Bank v. Investor)	Total Debt-to-Income Ratio	Trust Name if owned by Investors	Does 2nd Lien Exist?	Does the Servicer own 2nd lien?	Borrower State	Residual Income	Time to Complete Modification	Origination Date

Home Appraisal Value	Borrower LTV Before the Mod (1st Lien Only)	Borrower LTV After the Mod (1st Lien Only)	Borrower Combined LTV Before the Mod (All Liens)	Borrower Combined LTV Before the Mod (All Liens)					