Testimony of Martin S. Hughes

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Committee on Financial Services

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Building a Sustainable Housing Finance System: Examining Regulatory Impediments to Private Investment Capital

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Introduction
Good Morning Chairman Hensarling, 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. I appreciate the opportunity to testify on what can be done to accelerate the return of the private secondary mortgage market. I would also like to recognize diligent and thoughtful work of Congressman Garrett on this subject.

Overview
My testimony is singularly focused on the perspective of the institutional investors that are the buyers of the senior classes of mortgage backed securities ("MBS"). They are the single most critical variable to consider as you take steps to promote a robust private MBS market. Simply put, investors have the money, but without their participation there is no market.

In the wake of the financial crisis, investors in private MBS lost confidence that their rights and interests in the securities they purchased would be respected and consequently, that their investments were safe and secure. In response many senior-class MBS investors, who previously had significant asset allocations to the private MBS space, now have little or no participation at all. Today's financial world is awash with liquidity and investors are combing through different asset classes in search of safe, attractive yield. On a relative value basis, there is no logical reason why private MBS should not play a much larger role as an attractive investment class, as it was in the past.

So how do we get there? Broadly speaking, I believe we need to first address investors' demands for better risk mitigation, transparency, and alignment of interests throughout the mortgage chain. Redwood's fourteen successful securitization transactions post-crisis, totaling $5.6 billion, proves that it can be done. Secondly, the private MBS asset class needs a chance to grow in size and reach a level that creates sufficient incentive for investors to allocate resources and capital to the asset class. Until the private MBS asset class reaches a critical mass of volume, many large investors will find it uneconomic to research, monitor, and invest in the asset class. It may be viewed as somewhat of a catch-22, but in order for the private MBS market to grow, the government needs to level the playing field and cede space to private sector financing at a safe and measured pace. In the body of my testimony that follows, I will detail specific actionable recommendations to achieve both of these goals.

Background on Redwood

Redwood commenced operations in 1994 as an investor in residential mortgage credit risk. We do not originate or directly service residential mortgages. We currently operate a prime jumbo loan conduit where we acquire individual closed loans from commercial banks and mortgage companies primarily for pooling and sale through our Sequoia private securitization platform. Redwood protects senior investors in our MBS through our investment in the subordinate securities of each securitization, which enables the senior securities to obtain triple-A ratings. In Dodd-Frank parlance, we have always held "skin in the game" as part of our business model, which demonstrates our alignment of interest with senior investors.

From 1997 through 2007, Redwood securitized over $35 billion of mortgage loans through 52 securitizations. Our average loan size was $372,000 and, interestingly, 27% of the securitized loans were prime loans with balances under Fannie Mae and Freddie Mac's (the "GSEs") conforming loan limit.

Recent Securitization Activity

Since we restarted securitization in 2010, we have securitized $5.6 billion of jumbo loans in fourteen transactions. Our issuance velocity is accelerating as five of those fourteen transactions were completed in 2013. We plan to securitize $7.0 billion this year. Additionally, the credit performance of our post-crisis transactions has been stellar. We have not incurred a credit loss, nor have we had a loan go past 90 days delinquent for credit reasons.

We have listened to investors and worked hard to meet their new requirements by putting together transactions that included even more comprehensive disclosures, better and simpler structures, new enforcement mechanisms for representations and warranties, and our skin in the game.

Currently, 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 the GSEs for participation in their programs. We are limited to the jumbo market at this point because we cannot compete with the price and market advantages the government has conferred on the GSEs. Once the playing field is level, we stand ready to securitize prime loans of any size.

We are not that far off. On April 22, 2013, the rate Redwood was quoting for prime 30 year fixed jumbo rate (assuming a sale through private securitization) was 3.875%. This compares to Wells Fargo's prime 30 year fixed agency jumbo rate of 3.625%, and agency conforming rate of 3.50%. This is strong evidence that private capital will provide borrowers with loans on reasonable terms if investors are presented with well-structured securitizations that also have a proper alignment of interests between the sponsor and the triple-A investors.

RECOMMENDATIONS FOR GROWTH OF THE PRIVATE MBS MARKET

I would broadly describe my recommendations in three parts: first, correct MBS structural deficiencies and conflicts; second, give the private MBS market room to grow; and third, resolve pending regulations or institute a moratorium.

1. **CORRECT MBS STRUCTURAL DEFICIENCIES AND CONFLICTS**

The private market that Redwood has revived will have difficulty achieving velocity without the combined efforts of market participants, Congress, and regulators to correct structural deficiencies and conflicts. It is critical we strengthen the structural foundation that supports securitization so that investor protections are given greater emphasis. In traditional securitization structures, investors have relied on a trustee and a servicer to administer a securitization. The governing documents have not always addressed or contemplated all of the potential situations that could face the servicer or trustee or provided for an investor-friendly mechanism for initiating and resolving disputes.

- **Create a Private Market Advisory Committee, having investors as a majority of the membership, with the responsibility to establish best practices in representations and warranties and other key securitization terms. The standards would not be mandatory, but each securitization must clearly disclose any variation from the standards.**

Representations and warranties have been weak, and it has been difficult and costly to enforce the originator's or sponsor's obligations to repurchase loans where there has been a breach. We believe the representations and warranties now required by the GSEs serve as a strong benchmark. Certain contractual provisions may be vague or may not clearly delineate the rights of different tranches of a securitization or prevent manipulation of contractual cash flow triggers for the benefit of one tranche at the expense of another. Securitization trustees are not generally required to take proactive steps to protect investors. Excessive discretion may be placed in the hands of servicers without accountability to specified performance standards.

- **Establish binding arbitration as a minimum standard for dispute resolution of representation and warranty claim disputes.**

Some originators have resisted or stalled the process for legitimate claims, resulting in costly litigation. These problems have led to deep investor mistrust, and investors, unable to rely on this protection, have fled the securitization market and continue to sit on the

sidelines. In order to correct this problem, we recommend requiring a formal dispute resolution process for ensuring enforcement, specifically a binding arbitration standard. Standard representations and warranties coupled with binding arbitration would provide investors with assurance that any allegation of a violation of representations and warranties will be thoroughly investigated and pursued in an efficient manner.

- **Require that securitization trusts create the position of Credit Risk Manager to manage representation and warranty claims and monitor servicer performance and actions.**

The Credit Risk Manager ("CRM") will be an independent third-party unaffiliated with any interest in the transaction, and will have two primary responsibilities. The first is to identify, investigate, and pursue claims for breaches of representations and warranties. This is important in the event the senior investors and the party that owns the first loss security disagree on whether or not to pursue a claim. The second responsibility is to conduct ongoing surveillance of the servicer's activities and report to the trustee and investors the results of the review. Although a servicer is engaged to service mortgage loans in a securitization pool for the benefit of the investors, the investors have no real way of ensuring the servicer is performing because there is currently no independent review or quality control of the servicer's decisions. The securitization documentation should provide for the CRM to have the same access to loan information and original files as the servicer to ensure that the CRM has the information necessary to perform its responsibilities.

- **Establish clear and objective uniform standards governing the responsibilities and performance of a servicer in its role as a fiduciary of the trust.**

Focusing narrowly on the role of servicers in the securitization structure, they have sometimes been placed in the position of having to interpret vague contractual language, ambiguous requirements, and conflicting directions. In their role, they are required to operate in the best interest of the securitization trust 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 residential mortgage backed securities ("RMBS").

- **Prevent servicer conflicts of interest by prohibiting the owner of a second lien mortgage from being the servicer of the first lien mortgage on the same property.**

Currently, most second liens are owned by the same banks that perform servicing on first liens in which they have no financial interest. Therefore, servicers have a strong incentive to place their financial interests ahead of investors when taking actions on behalf of the trust. For example, a servicer could refuse to approve a loan modification or short sale that would benefit the first lien holder and homeowner, because doing so would directly harm their second lien financial interests.

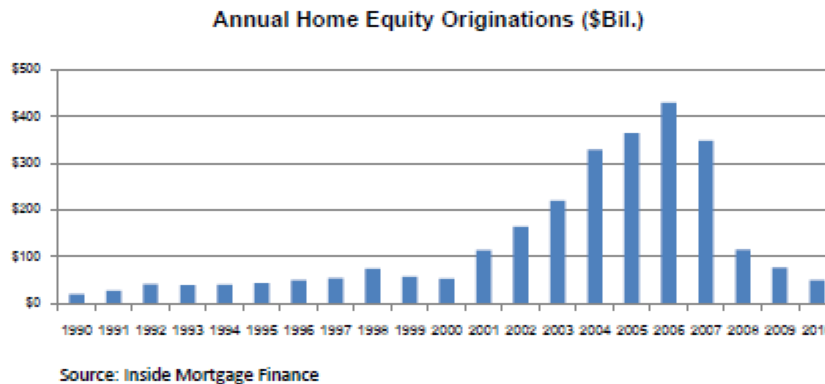
Fortunately, there is a simple fix to this problem. Simply prohibit the owner of a second lien mortgage from being the servicer of the first lien mortgage on the same property. Servicing a delinquent loan is a nuanced, complicated process and investors must believe that their servicers are acting as honest agents throughout. No amount of disclosure or other half-measures will alleviate these concerns. The only meaningful solution is to break the economic link between first lien servicers and second liens entirely.

- **Establish servicer performance triggers to serve as benchmarks and an objective means for possible removal of the servicer.**

The triggers, which could be set by the Private Market Advisory Committee I suggested above, might include, among other things, average loss severity, adherence to foreclosure timelines, and average REO liquidation timelines. The triggers should be reviewed on a periodic basis. If a servicer fails a trigger, servicing can be terminated. Mechanics must be established to facilitate collective action by investors when a trigger event occurs and there is a failure on the part of the trustee to take action.

- **Control the systemic and loan level risks of second lien mortgages by giving first lien holders the ability to require their consent to a second lien if the combined loan to value ("CLTV") with all other liens will exceed 80%.**

During the housing bubble, homeowners used second liens to extract record levels of home equity, and also as a substitute for cash down payments to purchase houses. At the peak in 2006, these loans totaled $430 billion.



The rise of home equity lending increased the monthly payment obligations for borrowers and reduced the amount of equity remaining in their homes, leaving borrowers vulnerable to home price declines. As a result, 38% of the borrowers who used these loans found themselves underwater (or owing more than the value of their houses), compared to only 18% of those who did not. Even for well-underwritten, prime loans, the presence of a second lien increased defaults by as much as 114%.

The rise of second liens has had another, less-widely understood effect: it substantially increased losses for investors and chilled their interest in investing in newly issued MBS. To understand why, it is necessary to understand how investors evaluate mortgage loans. While a borrower's credit report, income verification, and other underwriting factors are important, the most important factor is the amount of borrower equity, or down payment. The amount of borrower's equity is the most predictive factor for a borrower's future performance: borrowers with 20% or more equity have lower default rates, while those with no equity are quicker to walk away.

Second liens undermine this analysis by making down payment information unreliable. Imagine this scenario: a borrower applies for a first mortgage with a 40% down payment – a loan with very little historical default risk. As a result, the borrower is offered a great loan at a low rate. One week later, the borrower takes out a second mortgage from a different lender for the remaining 40% of the property value. The borrower no longer has any equity and the default risk and potential loss severity on the first lien is many times higher than before. This is not a fantasy scenario: 71% of borrowers in prime, privately securitized mortgages issued between 2004 and 2007 took out second liens that were not disclosed to the holder of the first mortgage.

This level of uncertainty has a highly consequential impact on the how investors assess mortgage related investments. Since investors have no way of knowing which borrowers will cash out their equity, they must assume that everyone will. This uncertainty leads private investors to demand higher rates in return for the increased risk and means that conservative borrowers will pay higher rates to offset the risk from more aggressive borrowers.

We believe that placing some reasonable restrictions on the origination of second lien mortgages will restore investor confidence and speed the transition of the mortgage market away from taxpayer exposure. We propose that first lien holders have the ability to require their consent to a second lien if the combined loan to value ("CLTV") with all other liens will exceed 80%. If the consent is not given, then the borrower can still obtain a home equity loan, but will need to refinance the first mortgage (and pay off the first lien holder) using a standard cash out refi loan product. This proposal would allow borrowers to tap into their equity, while preserving a level of protection for investors in first liens. This new restriction is intended only to protect first-lien lenders, and investors, from excessive equity being extracted later, without their knowledge or consent.

2. GIVE THE PRIVATE MBS MARKET ROOM TO GROW

- **The government must begin to reduce its participation in the mortgage market, gradually and at a measured pace, by continuing to increase guarantee fees that Fannie Mae and Freddie Mac charge, and by reducing their conforming loan limits.**

The government mortgage market (GSEs, FHA, and VA) and the private mortgage market co-existed to serve the needs of borrowers for many years. Together, the two segments supported the steady growth of the market, which grew to exceed $11 trillion by the end of 2007. From 1990 through 2007, the government's market share averaged 59%, while the private sector's market share averaged 41%. In the aftermath of the financial crisis, the government's share of the mortgage market has increased to approximately 90%.

Although the housing market is recovering and private securitizations are returning, the government continues to dominate the market because the GSE's guarantee fees are below market, and the conforming loan limit remains artificially high at $625,500. As a result, for several years now mortgage lenders have been able to achieve better loan pricing by selling their mortgages into government loan programs. With relatively few loans falling outside of the very wide government parameters, the private market must struggle for market share.

The private MBS market is further constrained by a banking industry that has ample liquidity to retain prime jumbo loans on their balance sheets, leaving few loans to be securitized. For example, over the last three years, $5.0 trillion of mortgage loans have been originated, of which $477 billion were non-government jumbo prime mortgage loans, and only $5 billion of the prime jumbo loans were securitized. With little private market issuance, it is easy for institutional investors to ignore the asset class, which then inhibits rebuilding the private securities market. Simply put, you can't expect a market to develop unless there is product available.

We note that post-crisis, the private asset-backed securities markets for auto loans, credit card loans, and commercial real estate loans are up and functioning, while the private RMBS market is barely developed beyond Redwood's program. One of the reasons is the pervasive below-market government financing in the residential mortgage sector that is crowding out traditional private market players.

We were encouraged by the Federal Housing Finance Agency's ("FHFA") actions last year to increase guarantee fees, and we hope those increases will continue until a level playing field has been established. Similarly, if the GSE's conforming loan limit is decreased, the private market would aggressively compete for the newly jumbo loans without any market disruption, similar to when the temporary increase (from $625,500 to $729,750) in the conforming loan limit was allowed to expire in September 2011.

3. RESOLVE PENDING REGULATIONS OR INSTITUTE A MORATORIUM

- **Remove the crippling uncertainty caused by unfinished regulations by requiring that the unfinished rules that are past deadline must be issued within 4 months, or be subject to a 4 year moratorium. This would provide certainty in the form of final rules or the status quo for a long enough period of time to allow a private MBS market to develop.**

The incomplete status of regulations required by the Dodd-Frank Act has constrained the development and growth of the private MBS market. Markets require certainty about the rules of operation so that regulatory compliance can be assured. Firms will be cautious about entering the private MBS market out of concern that final regulations might soon turn a good business decision into a bad one. Markets typically manage to adapt to new regulations and continue operating under the new rules. The private MBS market is no different, but I must

point out one very critical exception that would cause great harm to the development of the private MBS market.

The Credit Risk Retention proposed rule requires the creation of a Premium Capture Cash Reserve Account that would paralyze the private market if adopted. In addition to the basic 5% risk retention requirement of the rule, it would require the issuer of the MBS to fund a premium capture cash reserve account with the positive difference between projected cash flows on the loans and payments due on the securities. This new requirement is an unnecessary additional layer of credit enhancement that will make private MBS transactions uneconomic. These accounts were not required in the language of the Dodd-Frank Act, yet were included in the proposed rule. I hope the regulatory agencies writing the Credit Risk Retention rule will recognize the importance of this issue and remove the account from any final rule.

So my message here is simple, please get the rules right and get them out right away. The markets will generally adapt if the rules of the road are known. If the rules cannot be completed in a timely fashion, then let's recognize that and place a moratorium on their issuance.

FHFA Single Securitization Platform and Risk Sharing

Finally, your invitation letter asked for my views on the FHFA's recently announced plans to have the GSEs develop a single securitization platform and new risk sharing arrangements. Redwood supports the effort to modernize the infrastructure of the GSEs. We see benefits to standardizing operations across the two GSEs and the evolution of the risk sharing transactions using either a senior/sub or a synthetic structure. We do want to point to two areas of focus for us in the private label securitization market.

First, while the single platform will provide several benefits for the GSEs, expanding it to the private label market and requiring the implementation therein may unnecessarily constrain that market. Our view is that the implementation of a consistent single platform will serve as a good metric and consistent benchmark to enable private label security ("PLS") investors to quickly and efficiently compare the particular attributes of a private label securitization to that benchmark. While there is general consensus that standardization would be beneficial, the benefit comes from providing a benchmark, not through establishing a constraining mandatory framework.

Second, once the GSEs engage the credit markets in a risk sharing arrangement, the investor base for the non-government guaranteed securities will shift from a rate and pre-payment

sensitive investor base to a credit sensitive investor base. The investment analysis performed by credit investors is based more heavily on the credit attributes of the mortgage loans and borrowers as well as the structural mechanisms for representations and warranties and for enforcement mechanisms. Therefore, credit investors will need more robust disclosures and pre-securitization due diligence.

Conclusion

I commend you for focusing this hearing on investors. I firmly believe that the private secondary mortgage market can grow quickly to provide liquidity to a very large share of the mortgage market, without the need for any government guarantee, if the needs of investors are met and the government gives the private market room to grow.