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 PRIVATE MORTGAGE MARKET INVESTMENT ACT

DECEMEMBER 7, 2011

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Introduction

Chairman Garrett, Ranking Member Waters, and distinguished members of the Subcommittee, thank you for the opportunity for the Association of Mortgage Investors (AMI) to testify today. Our comments will focus on issues and concepts relating to the present draft legislative proposal, the "Private Mortgage Market Investment Act," and how its provisions impact the critically important topic of returning private capital to the U.S. mortgage market and restoring our markets.

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. As AMI has previously testified, the current mortgage investors suffer from a number of problems in the securitization space including:

- Market opacity, an asymmetry of information, and a thorough 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.

Accordingly, we commend Chairman Garrett and your colleagues for acknowledging these issues facing investors and our public institution partners and your efforts toward developing a solution. While we do not presently take an association position on the current draft, this proposal is an important step forward and fosters a healthy discussion of key issues and concepts. In light of the following testimony regarding problems obstructing the reemergence of private capital returning to the U.S. mortgage market, we would like to work with you and your colleagues in perfecting the legislation as it moves forward.

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. It was 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 stressed and by themselves are not enough to support a mortgage market of the size that U.S. homeowners have come to rely on; (2) the government (Fannie Mae, Freddie Mac, FHA); and, finally, (3) securitization, which is effectively shutdown for the reasons described herein.

At its height, today's U.S. mortgage market consisted 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

[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.

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.

Investors seek the government's development of enhanced structures, standards, and safeguards. These will promote the certainty, transparency, uniformity, enforcement, recourse, and other criteria that will contribute to improving the functioning of capital markets for all investment asset classes, especially those pertaining to a necessity of 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.

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

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.

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 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. 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).

[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).

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:

- **<u>Many Servicers are Conflicted; They May not be Servicing Mortgages Properly.</u>** 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]

- **<u>Originators and Issuers May not be Honoring their Contractual Representations</u>** about what they sold into securitizations. The past is prologue and there are no assurances that they will not repeat these practices in the future; and,

- **<u>The Market in General Lacks Sufficient Tools for First Lien Mortgage Holders</u>**, 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).

[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.

b. The Failure of RMBS Trustees in the Securitization Process

AMI and its members have experienced first-hand how the insufficient legal protections and failure of protecting investors' rights have harmed the public institutions with which we partner (*e.g.,* unions and pension funds) and caused private capital to leave mortgage investing. The most serious problems surround the role of the securitization trust (RMBS) Trustee failing to undertake the duties required by the common law and its contractual obligations pursuant to a PSA.

RMBS Trustees have certain important duties with respect to the Trusts they oversee – duties that are critical to preserving the core contractual rights afforded to investors under the relevant PSAs. These include (i) ascertaining pertinent facts regarding the underlying collateral and notifying all parties upon discovery of a breach of any party's obligations; (ii) providing investors with reasonable access to information regarding their investments; and, (iii) remedying servicer Events of Default and enforcing the cure, substitution, or repurchase of loans that breach representations and warranties. The following constitutes evidence that the parties to RMBS Trust agreements are engaging in substantial breaches of their contractual obligations, and notice that such breaches have gone largely unaddressed by RMBS Trustees. These examples are divided into two sections:

1. Evidence of the egregious underwriting deficiencies that have been discovered across residential mortgage securitizations issued in the years leading up to the 2008 financial crisis; and,
2. Evidence of servicer breaches of their obligations to service loans in RMBS Trusts in compliance with their servicing agreements and the best interests of Certificateholders.

Given the evidence detailed herein, AMI considers the Trustee to be on notice of serious threats to the assets and contractual rights underlying its RMBS Trusts.

i. Breaches of Representations and Warranties

The sale of loans into RMBS Trusts is typically governed by mortgage loan purchase agreements, which contain representations ("reps") and warranties made by the seller regarding the quality, underwriting process, payment history, and other fundamental characteristics of each loan. These reps and warranties were incorporated into the PSAs for the benefit of the Certificateholders. Pursuant to most PSAs, the seller must cure, substitute, or repurchase any loan that is found to contain a breach of reps and warranties that materially and adversely affects the value of the loan or Certificateholders' interest therein. The Trustee has an obligation to provide access to loan files, deal documents, and other pertinent information to investors upon receiving a request pursuant to the relevant terms of the PSA. Further, upon discovering or being notified of any such breach, it is the Trustee's duty under most PSAs to notify the responsible party and to "undertake commercially reasonable efforts to enforce the obligations" of the responsible party to cure, substitute, or repurchase such defective loans.

It is these important contractual provisions that provided investors with comfort regarding the quality of the loans that would serve as the collateral for their investments in RMBS. While investors were prepared to accept certain risk with respect to this collateral—these reps and warranties constituted investors' fundamental protection against the risk of misrepresentation, fraud, and abject underwriting failures in the underlying mortgage loans—risks that were entirely within the control of the originators and sellers of these loans. For this reason, the following evidence regarding pervasive breaches of reps and warranties, and the Trustees' failure to enforce the same, is particularly troubling.

The following findings are but a few examples of the egregious underwriting deficiencies that have been discovered across RMBS pools from the years leading up to the 2008 financial crisis. In April 2011, the United States Senate Permanent Subcommittee on Investigations released a bipartisan report detailing the findings of its two-year investigation into the causes of the crisis.[5] The Senate Subcommittee focused on Washington Mutual Bank ("WaMu") as a case study of lender conduct during this time, and concluded that WaMu had engaged extensively in improper loan underwriting practices,

[5] "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," United States Senate Permanent Subcommittee on Investigations, April 13, 2011, *available at* http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf.

including steering borrowers into riskier loans than those they could afford; failing to verify borrower income or enforce compliance with its own underwriting guidelines; authorizing loans with multiple layers of risk, underwriting exceptions, and/or erroneous or fraudulent borrower information; and incentivizing loan personnel to quickly generate large volumes of higher risk loans without regard for loan quality.[6] The Senate Subcommittee concluded that,

> *unacceptable lending and securitization practices were not restricted to Washington Mutual, but were present at a host of financial institutions that originated, sold, and securitized billions of dollars in high risk, poor quality home loans that inundated U.S. financial markets…These lenders were not the victims of the financial crisis; the high risk loans they issued were the fuel that ignited the financial crisis.*[7]

Consistent with these findings, several bond insurers have reported discovering widespread breaches of reps and warranties in RMBS loan pools from the years leading up to the financial crisis. In a review of approximately 15,500 defaulted first lien loans and 37,500 defaulted second lien loans, Assured Guaranty found that 14,500 (93%) and 33,100 (88%), respectively, breached reps and warranties.[8] Ambac Assurance Corp. conducted a review of 6,309 loans securitized by Bear Stearns and found that 5,724 (91%) breached reps and warranties; Ambac reports that out of the loans found to have breaches, Bear Stearns has agreed to date to repurchase only 52 (less than 1%), and has in fact not repurchased a single one.[9] In separate lawsuits against Countrywide and Bank of America, MBIA Insurance Corp. reports having found that nearly 90%[10] and approximately 91%[11] of the defaulted or delinquent loans in Countrywide securitizations show material discrepancies from Countrywide's reps and warranties.

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[6] *Id.* at 3.

[7] *Id.* at 4.

[8] Assured Guaranty Ltd., Annual Report (Form 10-K), at 105 (March 1, 2011).

[9] *Ambac Assurance Corp. v. EMC*, *et al*., Case No. 08-CV-9464 (S.D.N.Y. 2008) (First Amended Complaint ¶28).

[10] *MBIA Ins. Corp. v. Countrywide Home Loans, et al.*, Case No. 08602825 (N.Y. Sup. Ct. 2008) (Complaint ¶59).

Other findings from across the industry suggest extensive underwriting deficiencies throughout RMBS Trusts. In 2007, Fitch Ratings conducted a review of subprime underwriting practices, in which it found that,

> *[i]n many instances, misrepresentations and altered documentation are evident in the physical files... Often, loans containing misrepresentations have multiple problems that can be detected through a strong validation and reverification process.*[12]

In particular, Fitch analyzed 45 loans with early payment defaults and found the results "disconcerting at best, as there was the appearance of fraud or misrepresentation in almost every file." In 2009, the Federal Home Loan Banks conducted a study of subprime and Alt-A loans in which they found that 54.5% of 2007-vintage loans, 49.1% of 2006-vintage loans, and 43.2% of 2005-vintage loans were eligible for repurchase based on breaches of reps and warranties.[13] Due diligence or forensic loan auditing firms have noted similar findings, with the Barrent Group reporting that 69.9% of Alt-A loans reviewed from the 2006-07 period contained breaches of the underwriting guidelines while Recovco Management, LLC has found that over half of the several thousand loans reviewed from the 2006-07 period contained material breaches of reps and warranties.

As the holder of the Trust fund for the benefit of Certificateholders, the Trustee has a duty under most PSAs to exercise reasonable care in "ascertaining the pertinent facts." As the Custodian of the

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[11] *MBIA Ins. Corp. v. Bank of America Corp., et al.,* Case No. BC417572 (Cal. Super. Ct. 2009) (Complaint ¶80)

[12] M. Diane Pendley, et al., "The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance," *Fitch Ratings US Residential Mortgage Special Report*, Nov. 28, 2007, at 4-6, *available at* http://www.mortgagebankers.org/files/News/InternalResource/58467_TheImpactofPoorUnderwritingPracticesandFraudinSubprimeRMBSPerformance.pdf.

[13] Chris Gamaitoni, Jason Stewart and Mike Turner, "Mortgage Repurchases Part II: Private Label RMBS Investors Take Aim - Quantifying the Risks,*" Compass Point Research & Trading*, August 17, 2010, *available at* http://api.ning.com/files/fiCVZyzNTkoAzUdzhSWYNuHv33*Ur5ZYBh3S08zo*phyT79SFi0TOpPG7klHe3h8RXKKyphNZqqytZrXQKbMxv4R3F6fN5dI/36431113MortgageFinanceRepurchasesPrivateLabel08172010.pdf.

relevant trust documents and loan files in many deals, or the as the party with the authority to direct the Custodian, the Trustee has an obligation to provide investors with reasonable access rights to information regarding their investments. The Trustee also has a duty to enforce the cure, substitution, and repurchase obligations of the parties to the PSA within the prescribed cure period when it becomes aware or should become aware of a material breach of reps and warranties. Pursuant to these contractual provisions, the repurchase price for any loans repurchased should include amounts for accrued interest and advances, and such repurchase amounts should be included in the remit provided to investors (requirements with which investors are seeing inconsistent compliance, at best). The Trustee may incur liability should it fail to comply with these duties, or act in a negligent manner in carrying out these duties. Given the significant evidence that material breaches are prevalent within RMBS Trusts, and that Trustees have rarely exercised their duties to ascertain these facts or enforce repurchase obligations, these liabilities are potentially extensive.

ii. Servicing Breaches

The conduct of mortgage servicers is governed by servicing agreements, which require these entities to service securitized mortgage loans in the best interests of the ultimate Certificateholders. However, many of the largest servicers are affiliates of the lenders that originated the loans at issue. These prior origination activities have created significant conflicts of interest for mortgage servicers, encouraging them to enrich their own interests over those of the Certificateholders they are contractually obligated to protect. For example, where a servicer controls the servicing for a borrower’s first and second lien loans, but only owns the second lien, this creates conflicts that encourage the servicer to maximize the value of the second lien at the expense of the first. A study published by the National Bureau of Economic Research found that a modification program implemented by Countrywide Financial Corporation as part of settlement with state Attorneys General resulted in a substantial increase in voluntary or “strategic” defaults by borrowers on first lien loans, without a corresponding increase in strategic defaults on second lien loans.[14] As Countrywide no longer owns 88% of the first liens at issue, but holds a large majority of the second liens,[15] these findings suggest that Countrywide is encouraging delinquent borrowers to pay second liens *in lieu* of first liens, thereby protecting its interests at the expense of the interests of investors.

These conflicts and others have led to widespread servicer breaches of their obligations to service loans in RMBS Trusts in the interests of the ultimate Certificateholders. The following are just some examples of these breaches.

iii. Failure to Report Rep and Warranty Breaches

When servicers discover any material breach of a loan seller's reps and warranties, they are obligated by most PSAs to "give prompt notice thereof to the other parties." Servicers are also in the best position to determine whether there has been any such breaches because they regularly (i) interact with borrowers in collecting loan payments and are privy to borrower statements that may contradict information in their loan files; (ii) conduct in-depth reviews of loan files in the course of evaluating potential loan modifications; and, (iii) are put on notice of potential breaches by bond insurer and investor lawsuits, such as those discussed in this letter. Nevertheless, servicers have failed to give notice to Trustees or investors of any breaches, primarily because the servicers, as affiliates of the loan originators and/or sellers, would often be the ones required to buy back any deficient loans.[16] This conflict of interest has led to the failure

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[14] Chris Mayer, Ed Morrison, Tomasz Piskorski, and Arpit Gupta, "Mortgage Modification and Strategic Behavior: Evidence from a Legal Settlement with Countrywide," *National Bureau of Economic Research*, Working Paper No. 17065, May 9, 2011, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1836451.

[15] Alex Ulam, "The Bank of America Mortgage Settlement Fiasco," *The Nation*, October 13, 2010, http://www.thenation.com/article/155380/bank-america-mortgage-settlement-fiasco?page=0,1.

[16] *See, e.g.*, Letter from Kathy Patrick to Countrywide Home Loans Servicing and Bank of New York, October 18, 2010, *available at* http://www.businessinsider.com/bondholers-letter-to-bank-of-america--over-countrywide-loans-2010-10; *Deutsche Bank National Trust Co. v. FDIC, et al.*, 09-CV-1656-RMC (D.C.D.C. 2009) (Complaint ¶82); Laurie Goodman, Roger Ashworth, Brian Landy, and Liclan Yang, "The Elephant in the Room—Conflicts of Interest in Residential Mortgage Securitizations", *Amherst Mortgage Insight*, at 15, May 20, 2010 (only 37% of early payment defaults have been repurchased out of the trust).

by servicers to report findings of clear fraud and misrepresentation relating to mortgage loans held in securitization.[17]

This conflict is illustrated by the discrepancy between the manner in which servicers handle loans in their own portfolios and the manner in which they service loans on behalf of investors or Government Sponsored Enterprises ("GSEs"). For example, the OCC and OTS issued a Mortgage Metrics Report for the third quarter of 2009 that found that, "[s]ervicers continue to modify more loans held in their portfolios than they did [*sic*] for the GSEs, government-guaranteed loans, or for private investors. Loans serviced for the GSEs accounted for 18.7 percent of all modifications despite making up 63 percent of the servicing portfolio."[18] These findings demonstrate that banks are more willing to engage in loan modifications (especially principal loan modifications) when they hold loans in portfolio. In contrast, when they service loans for others, servicers earn higher servicing fees if loans remain in delinquency with higher principal balances, and are neither repurchased nor resolved.

The Trustee should not permit servicers to subordinate investors' interests to their own. If servicers discover breaches of reps and warranties in the portfolios they service for others, they can and should be reporting these breaches to the other parties to the PSA, just as they should be modifying loans in these portfolios, where appropriate. The Trustee must ensure that servicers comply with their obligations to service such loans in the best interests of Certificateholders, and should exercise its right to declare a servicer Event of Default and replace any servicer that is too conflicted to do so.

[17] U.S. Representative Brad Miller, Letter to JPMorgan Chase Home Lending, June 17, 2010, at 2 n.4 (citing sources) (letter on file with AMI).

[18] U.S. Department of the Treasury, "OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data," December 2009, 25, *available at* http://www.occ.gov/publications/publications-by-type/other-publications/mortgage-metrics-q3-2009/mortgage-metrics-q3-2009-pdf.pdf.

iv. Improper Servicing of Delinquencies

Servicers encounter additional conflicts with their obligation to service in the best interests of Certificateholders when servicing delinquent mortgages. Servicers often earn more fees from foreclosing than they would from engaging in loan modifications, thereby creating incentives for servicers to foreclose on borrowers that might qualify for a workout.[19]

AMI supports effective, long-term solutions for responsible homeowners seeking to stay in their homes, including sustainable loan modifications, where appropriate. By all accounts, servicers are failing miserably in this capacity.

In April 2011, the U.S. Treasury announced that it was withholding incentive payments to three servicers – Bank of America, Wells Fargo, and JPMorgan Chase – based on noncompliance with the Making Home Affordable Program.[20] This decision stemmed from a report of the Treasury compliance team that found, among other things, that servicers were making income calculations errors (defined as a difference of at least 5% between the income calculated by the servicer and the Treasury compliance team) on a substantial percentage of modification assessments.[21] In particular, Bank of America was found to have made income calculation errors on 22% of assessments, Wells Fargo on 27% of assessments, JPMorgan on 31% of assessments, and Ocwen on 33% of assessments. These numbers suggest that servicers are not conducting their servicing duties in investors' best interests.

[19] Kurt Eggert, "Limiting Abuse and Opportunism by Mortgage Servicers," 15 HOUSING POL'Y DEBATE 753, 757 (2004) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=992095.

[20] "Obama Administration Releases May Housing Scorecard Featuring New Making Home Affordable Servicer Assessments," *U.S. Department of the Treasury*, press release, June 9, 2011, *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg1205.aspx.

[21] U.S. Department of the Treasury and the Department of Housing and Urban Development, "Making Home Affordable" Program Performance Report Through April 2011," June 9, 2011, at 16-36, *available at* http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/April%202011%20MHA%20Report%20FINAL.PDF.

Of course, if no arrangement can be made to recover delinquent payments and/or modify the loan, servicers have an obligation to use reasonable efforts to foreclose. Instead, as widely reported by research analysts, servicers are often keeping mortgages in delinquency for extended periods, which maximizes servicing fee proceeds.[22] Further, with respect to such delinquent loans, servicers have been increasingly disregarding their obligation to advance principal and interest payments to RMBS Trusts, despite the fact that these payments are recoverable from liquidation cash flows, borrower repayments upon cure, or deal cash flows in the case of workouts with principal and interest recapitalization. In general, the servicer should stop advancing payments on a loan only if it deems the loan in good faith to be "non-recoverable." However, since there is no clear definition of "non-recoverable" in most PSAs, servicers have begun to deviate from accepted and established servicing practices to limit their financing costs at the expense of investor interests. Indeed, stop advance rates have been steadily increasing over the past 12-18 months (particularly with respect to subprime mortgages), thereby depleting cash flows to investors, lengthening repayment timelines, and resulting in significant value destruction in RMBS.[23] Pursuant to governing PSAs, servicers must implement loss mitigation efforts, if appropriate, in a timely fashion, and must continue making servicing advances should loans remain in delinquency. Certificateholders are entitled to Trustee assistance to research and preserve these important contractual rights, and the failure to take such actions could lead to irreparable harm to the Trust and Certificateholders.

III. **Solutions Required by Mortgage Investors to Bring Back Private Capital**

The current legal and regulatory landscape presents numerous obstacles for the MBS securitization and restoring private capital, 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

[22] *See, e.g.,* "The Elephant in the Room," at 23.

[23] Barclays Capital, "Securitisation Research: Stop Advances – Trends and implications," June 3, 2011.

varied and numerous in the RMBS context. 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, recently, 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.*[24]

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.

We are pleased that the current draft proposal acknowledges and reflect AMI's past concerns and recommendations. We are pleased that the following AMI recommendations to enhance transparency and best securitization practices within capital markets are reflected in the bill:

[24] 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).

- *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 (Draft Bill, § 201).*
- *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. (Draft Bill, § 202).*
- *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. (Draft Bill, §201).*
- *Develop, for each asset class, standard pooling and servicing agreements with model representations and warranties as a non-waivable industry minimum standard. (Draft Bill, § 101).*
- *Develop clear standard definitions for securitization markets. (Draft Bill, §101).*
- *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. (Draft Bill, §101).*
- *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. (Draft Bill, § 101).*
- *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. .*

a. Investors Require Additional Protections, such as those included in the SEC's Proposed Reg AB

In 2010, mortgage investors and a range of other organizations submitted comments to the S.E.C. in support of its proposed Reg AB.[25] As part of the discussion of the concepts in the draft legislation presently before the panel, we wish to provide the following feedback. We must restate and emphasize our support for concepts and solutions that the proposed Regulation AB provides. As we have explained, AMI members believe that much of the dysfunction in the ABS market can be traced to (1) a lack of transparency; (2) subjective representations and warranties which, compounded by weak remedy enforcement, unfairly limits sponsors' and loan sellers' liability; and, (3) the financial decoupling and misalignment of interests of sponsors, originators and depositors from the interests of investors through reducing and in many cases eliminating their financial interests in the performance of ABS pools. We believe that the S.E.C. correctly responded by proposing common-sense reform involving three broad areas:

- **Securities Act shelf registration reform** - significant improvements involving risk retention, new certifications and expanded investor review timelines;
- **Expanded disclosure requirements** – enhanced data requirements both at issuance and on a go-forward basis at the asset and pool level as well as the historical experience of sponsors and originators involving repurchase claims; in addition, requiring from issuers a common platform cash flow model; and,
- **144A and new disclosure provisions** – requiring issuers to make available similar disclosure information to that offered in public market ABS.

The present legislative draft proposes an independent third party to act on behalf of the interests of investors. While we appreciate the spirit and intent of this concept, it falls far short from the necessary investor protection mechanism envisioned by the Reg AB, a Credit Risk Manager ("CRM"). The need to appoint a CRM arises from the long-standing abuses and possible conflicts we have extensively described.

[25] AMI's Reg AB comment letter may be found online at www.the-ami.org.

A qualified CRM, selected by the issuer subject to, *inter alia*, a representation of its independence from other parties to the ABS trust, will represent the interests of all Certificateholders (bond-holders) in investigating and, if warranted, pursuing representation and warranty claims against responsible parties. Although the CRM would have the unilateral discretion to pursue such claims as a fiduciary to the Certificateholders, individual or collective investor interests could require the CRM to launch investigations on well-founded investor suspicions. Expanding on existing concepts of voting rights commonly found in existing pooling and servicing agreements, voting rights aggregating greater than 25% of such interests outstanding could impel the CRM investigation at the expense of the trust. Investors representing below 25% of aggregate voting rights could require such investigation, but only at the expense of the inquiring investor(s). In discharging its obligations as a compensated party to the pooling and servicing agreement, the CRM must have complete access to loan and servicing files in order to conduct a proper examination and effectively pursue resulting claims. We look forward to working with the Committee on addressing this concept in the current legislative draft, as well as the other expanded disclosure and legal mechanisms, to permit them to operate in a fashion that can truly protect investors from long-standing abuses (*i.e.*, conflicts of interest) and help us to bring private capital back into the mortgage market, restoring the mortgage and securitization "plumbing," and the national note recordation system.

IV. Conclusion

Mortgage investors believe that the vibrancy and effectiveness of the U.S. capital markets can be restored and private capital will return, 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 and crafting legislative solutions concerning the many issues under review. Please feel free to contact me directly at Chris Katopis, Executive Director, 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.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Chris J. Katopis	Association of Mortgage Investors (AMI)

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☑ No	☐ Yes ☑ No

6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

Please attach a copy of this form to your written testimony.