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

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

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

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

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

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

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

## A Better Solution

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

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

The Need for Disclosure

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

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

Contracts that Work

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

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

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

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

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

## Why Standards Matter

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

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

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

## True Sale

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

## Collateral Servicing and Fiduciary Obligations

When a pool of first lien mortgages is created and sold into a trust, a servicer is chosen to service the loans, collect the mortgage payments and direct the cash flows to investors as defined by agreement. While investors in different tranches to the securitization may not

always have aligned interests, in light of the significant numbers of mortgages today that have negative equity most of the remaining holders would be willing to write down the principle balance of the loan if they would result in re-performance of collateral. For example, assume a 20% reduction in the principal balance of a mortgage would result in a borrower becoming willing and able to make payments and become current again, on a sustainable basis. This 20% loss, though significant, would surely be preferable to the potential 70%-plus loss investors could experience upon default and a subsequent foreclosure.

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

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

Housing Policy is a Different Matter

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

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

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

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

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

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

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

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

Such programs would reduce the need for subsidies to be delivered through the mortgage finance system. Furthermore, although they would require increased modeling of

prepayment risk, they would reduce credit risk and also reliance on the 30-year mortgage product.

## Conclusion

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

[i] Josh Rosner "Securitization: Taming the Wild West", Roosevelt Institute Conference, March 3, 2010 available at: http://makemarketsbemarkets.org/modals/report_securitization.php

[ii] http://www.sec.gov/rules/final/2010/33-9146.pdf

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

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

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

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

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

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

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

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

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

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

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

United States House of Representatives
# Committee on Financial Services

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| Josh Rosner | Self |
| 3. Business Address and telephone number: | |
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| 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? |
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